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Corporate Organizational Documents and Securities - Forms and comment

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CORPORATE ORGANIZATIONAL DOCUMENTS AND SECURITIES—FORMS AND COMMENTS

by

*Alan R. Bromberg**

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[The longer documents have separate tables of contents at their heads.]

The building blocks of a corporation are its articles, bylaws, securities and related documents. The forms and comments published here have evolved in my practice and my teaching since the 1950's. Earlier versions have been used by my former students in their practices. More recently, some of the forms and comments have been distributed by the Section on Corporation, Banking and Business Law of the State Bar of Texas.¹ I have now thoroughly revised them to reflect recent developments, particularly the 1973 amendments to the Texas Business Corporation Act.²

The forms are neither as simple nor as complex as they might be. They seek a middle ground, covering basic problems and needs, and leaving most of the esoteric points to the footnotes. The forms are designed for a closely

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1. INCORPORATION PLANNING IN TEXAS (G. Pelletier ed. 1970, rev. 1973).

2. See TEX. BUS. CORP. ACT ANN. arts. 1.01-11.01 (Supp. 1975) [hereinafter cited, e.g., as TBCA 1.01-11.01 (Supp. 1975)]. For an exhaustive article concerning these revisions see Lebowitz, *Recent Developments in Texas Corporation Law* (pts. 1, 2), 28 Sw. L.J. 641, 823 (1974).

held corporation. The notes indicate how they would differ for a "close corporation" under the 1973 amendments, or for a publicly held company. I regard the forms as oriented toward management power and flexibility. But my sensitivity to the securities laws, and their incursion into corporate affairs, leads to more investor-protecting features than appear in the usual forms.

Charters, bylaws and stock certificates must in large measure conform to the relevant corporate statute, and these are designed for the Texas Act. The minutes, warrant and convertible note are largely free from statutory requirements and might be used anywhere. Even the Texas-oriented parts should be adaptable in other states, particularly those with statutes based, like Texas', on the Model Business Corporation Act.

Corporate forms are already available in abundance. In adding to the supply, I have tried to achieve these things: depth of commentary, coordination of forms inter se, identification of significant variables and pitfalls, forthright judgments about the desirability and efficacy of various provisions, and identification and implementation of tax and securities law objectives. I hope my drafting is a bit more precise and less turgid than the usual corporate verbiage.

I will welcome critical comments from readers.

I. ARTICLES OF INCORPORATION OF ABC CORP.³

Contents

Required Provisions

1. Name
2. Duration

3. These articles were prepared to comply with Texas law, particularly TBCA 3.02 (Supp. 1975) and contain: (1) required provisions, each followed by an explanatory footnote which discusses relevant matters such as statutory source, permissible variations, and useful references; (2) optional provisions of general use, each followed by a footnote exploring the desirability of their inclusion in the corporate charter; and (3) a checklist of other optional provisions. The required provisions (§§ 1-8) of these articles are about as short and simple as will be acceptable. The major optional provisions (§§ 9-17) cover more esoteric matters particularly applicable to closely held or publicly held companies. These articles generally favor management and large shareholders but the alternative clauses and the footnotes indicate methods by which minority shareholders may be further protected. With respect to drafting corporate charters see generally C. ISRAELS, *CORPORATE PRACTICE* (3d ed. 1974) (mostly Delaware and New York); K. PANTZER & R. DEER, *THE DRAFTING OF CORPORATE CHARTERS AND BYLAWS* (2d ed. 1968) (Model Business Corporation Act, from which the TBCA was largely drawn); C. RORLICH, *ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES* (4th ed. 1967); G. SEWARD, *BASIC CORPORATE PRACTICE* 44-50, 115-44 (1966, Supp. 1969) (Delaware, New York, Model Business Corporation Act).

These articles are for general business corporations and do not cover those businesses required to incorporate under special statutes. See, e.g., TEX. REV. CIV. STAT. ANN. art. 342-304 (1973) (banks); *id.* art. 852a, § 2.01 (1964) (savings and loan associations); *id.* art. 1528e (Supp. 1974) (professional corporations); TEX. INS. CODE ANN. art. 3.02 (1963) (life insurance companies); *id.* art. 2.02 (other insurance companies). Nor do they cover nonprofit corporations. See TEX. REV. CIV. STAT. ANN. art. 1396 (Supp. 1974); Bromberg, *Non-Profit Corporations: Organizational Problems and Tax Exemptions*, 17 BAYLOR L. REV. 125 (1965).

The Texas Secretary of State has published a useful volume describing the services performed by his office in the incorporation process and the problems commonly encountered there. M. WHITE, *FILING GUIDE FOR CORPORATION AND LIMITED PARTNERSHIP INSTRUMENTS* (1974) [hereinafter cited as *FILING GUIDE*]. It also includes texts of the relevant statutes and may be purchased from his office.

3. Purpose [All Inclusive Form]
- Alternate 3. Purposes [Broadly Detailed Form]
- Alternate 3. Purposes [Alternate Short Form]
4. Shares
5. Commencement of Business
6. Registered Office and Agent
7. Initial Directors
8. Incorporators

Major Optional Provisions

9. Pre-Emptive Rights
10. Bylaws
11. Number of Votes
12. Majority Votes
- Alternate 12. 80% Votes
13. Non-Cumulative Voting
- Alternate 13. Cumulative Voting
14. Shareholder Management
15. Optional Dissolution
16. Interested Directors, Officers and Security Holders
17. Indemnification; Insurance

Other Optional Provisions—A Checklist

We, the undersigned natural persons of the age of twenty-one years or more, at least two of whom are citizens of the State of Texas, acting as incorporators of a corporation under the Texas Business Corporation Act, hereby adopt the following Articles of Incorporation for such corporation:

A. Required Provisions⁴

1. NAME.⁵ The name of the corporation is ABC CORP.

4. The required provisions closely follow the Form Promulgated by Secretary of State, 3A TEX. REV. CIV. STAT. ANN. 183-84 (1956) and the more recent FILING GUIDE 15-18. See also Comments of Bar Committee, 3A TEX. REV. CIV. STAT. ANN. 181-83, 184-86 (1956). See generally R. HAMILTON, TEXAS PRACTICE—BUSINESS ORGANIZATIONS §§ 260-74 (1973) [hereinafter cited as HAMILTON]; Campbell, *The Drafting of Articles of Incorporation and Bylaws Under TBCA*, 3A TEX. REV. CIV. STAT. ANN. 576 (1956); Lee & Pelletier, *Drafting the Articles of Incorporation—Some Comments and Suggestions*, 7 BULL. OF SEC. ON CORP., BANK. & BUS. LAW (State Bar of Tex.) (No. 3, Jan. 1969) at 1; Pelletier & Marsh, *Incorporation Planning in Texas*, 23 SW. L.J. 820 (1969) [hereinafter cited as 23 SW. L.J.], revised and reprinted as Pelletier, *Incorporation Planning in Texas*, in INCORPORATION PLANNING IN TEXAS 1-46 (G. Pelletier ed. 1973); Wolf, *Organizing A Close Corporation in Texas*, 27 TEX. B.J. 325 (1964).

5. (A) The choice of a corporate name is limited by TBCA 2.05 (1956). The statute prohibits a name that is deceptive through its similarity to the name of another corporation (without mentioning noncorporate businesses) or by way of indicating a purpose not contained in the articles of incorporation. Cf. State Bd. of Registration for Professional Eng'rs v. Wichita Eng'r Co., 504 S.W.2d 606 (Tex. Civ. App.—Fort Worth 1973), error ref. n.r.e. (injunction against use of "Engineers" in name of corporation failing to comply with Texas Engineering Practice Act, TEX. REV. CIV. STAT. ANN. art. 3271a, § 18 (1965)). On corporate names generally see 23 SW. L.J. 824-25; Lake, *Check List for Corporate Names and Purpose Clauses Under TBCA*, 23 TEX. B.J. 827 (1960); FILING GUIDE 7-9.

(B) The procedure for reserving a name is set forth in TBCA 2.06 (1956) and the filing fees are specified in TBCA 10.01(A)(8), (9) (Supp. 1975).

2. DURATION.⁶ The period of its duration is perpetual.

3. PURPOSE [ALL INCLUSIVE FORM].⁷ The purpose for which the corporation is organized is the transaction of any or all lawful business.

Alternate 3. PURPOSES [BROADLY DETAILED FORM].⁸ The purposes for which the corporation is organized are:

(C) "Company" or "Co.," though permitted by statute, should be avoided since it also may be used by unincorporated businesses and therefore fails clearly to identify the concern as a corporation; its use may result in personal liability on obligations not plainly identified as corporate. *See, e.g.,* Chiles v. Mann & Mann, Inc., 240 Ark. 527, 400 S.W.2d 667 (1966); Annot., 82 A.L.R.2d 424 (1962).

(D) Apart from the state requirement that the corporation's name be consistent with its purposes (TBCA 2.05(A)(2) (1956)) the Securities Exchange Commission, in effect, requires that the name of a corporation registering for a public offering of its securities not indicate that it engages in a line of business unless it is actually and substantially engaged in that line of business. SEC Registration Guide 54, Securities Act Release No. 5005, 1 CCH FED. SEC. L. REP. ¶ 3814 (Sept. 17, 1969).

(E) Incorporation of an existing "firm" (presumably either a partnership or a proprietorship) without change of name requires four weeks of newspaper publication notice. Without such notice, "no change shall take place in the liability of such firm or the members thereof." Texas Miscellaneous Corporation Laws Act § 2.02, TEX. REV. CIV. STAT. ANN. art. 1302-2.02 (1962). Query whether a slight alteration in the corporate name will make the notice requirement inapplicable? "Smith Company" to "Smith Corp.?" "Smith Company" to "Smith Service Company?" *See generally* HAMILTON §§ 252-53.

6. *See* TBCA 2.02(A)(1), 3.02(A)(2) (Supp. 1975). Although a perpetual duration is almost invariably preferable, a limited duration (*e.g.*, 10 years) may be used instead. Dissolution is always possible by shareholder vote under TBCA 6.02, 6.03 (Supp. 1975) or by optional provisions for close corporations (*see* note 22 *infra*).

7. (A) The purpose for incorporation no longer need be fully stated if the "all lawful business" language is used. TBCA 2.02(A), 3.02(A)(3) (Supp. 1975). This language also may be used in addition to specifically stated purposes. Even with the "all lawful business" phrase, the corporation is barred from: (1) banking, insurance, railroading and other activities specified in TBCA 2.01(B)(4) (1956) (separate statutes govern incorporation for these activities); and (2) unrestricted ownership of land as provided in Texas Miscellaneous Corporation Laws Act §§ 4.01-.07, TEX. REV. CIV. STAT. ANN. arts. 1302-4.01 to .07 (1962).

(B) There are many factors to consider in choosing between broad and narrow purposes. For example, broad purposes tend to: (1) increase the apparent authority of officers and employees to impose liability on the corporation; (2) increase the scope of the fiduciary duty of directors and officers not to usurp corporate opportunities; and (3) avoid the need to amend the articles of incorporation when the nature of the business changes. Narrow purposes, on the other hand, tend to protect investors against unexpected risks through change in the nature of the business, and create rigidity in the scope of the business. The "all lawful business" form is usually preferable unless there is a perceived reason to confine corporate activity.

(C) Since TBCA 2.04 (1956) abolishes the defense of ultra vires, the breadth or narrowness of the purposes is unlikely to affect dealings between the corporation and third persons. But acts outside the stated purposes can be challenged by shareholders or by the state (rarely done). TBCA 2.04(B)(1), (3) (1956).

8. (A) Multiple purposes are permitted subject to certain restrictions. TBCA 2.01 (1956). Real estate purposes are permitted only in substantially the form here used. TBCA 2.02(C) (1956). Texas Miscellaneous Corporation Laws Act §§ 4.04, 4.05, TEX. REV. CIV. STAT. ANN. arts. 1302-4.04, -4.05 (1962). It is often wise to include several broad purposes, whether or not they are expected to be used in the foreseeable future. In addition, any intended specific purpose should be stated (*e.g.*, "to operate filling stations" or "to manufacture electronic equipment"). Paragraph (H) is often included, though unnecessary, because of TBCA 2.02(A) (Supp. 1975) especially (20). *See* 23 Sw. L.J. 825-27.

(B) Purposes are to be distinguished from powers. *See* TBCA 2.02, 3.02(B) (Supp. 1975). To list powers as purposes in the charter creates confusion, adds nothing, and may lead to complications including the implied negation of unstated powers. *See* 23 Sw. L.J. 835-37.

(C) Many lawyers are tempted to include purposes such as borrowing and lending money or dealing in securities. If these are really to be the corporate purposes, as in a loan company or securities dealership, they should be included. TBCA 3.02(A)(3)

- (A) to buy and sell goods;
- (B) to perform services;
- (C) to transact any manufacturing business;
- (D) to engage in any mercantile or trading business;
- (E) to erect or repair any building or improvement;
- (F) to engage in the oil and gas business;
- (G) to buy, sell, acquire by lease, grant by lease, rent, sublease and subdivide real property in towns, cities, and villages and their suburbs not extending more than two miles beyond their limits;
- (H) to do everything necessary, proper, advisable or convenient for the accomplishment or furtherance of these purposes.

Alternate 3. PURPOSES [ALTERNATE SHORT FORM]. The purpose of the corporation is to buy, sell and deal in personal property, real property and services subject to Part Four of the Texas Miscellaneous Corporation Laws Act.

4. SHARES.⁹ The aggregate number of shares which the corporation has authority to issue is ten thousand shares of the par value of one dollar (\$1) each. The shares are designated as Common Stock and have identical rights and privileges in every respect.

5. COMMENCEMENT OF BUSINESS.¹⁰ The corporation will not commence business until it has received for the issuance of its shares considera-

(Supp. 1975). If they are to be merely powers incidental to a broader business, they already belong to all corporations, TBCA 2.02(A)(9), (10), (7) (Supp. 1975). Consequently they need not be specified in the charter, TBCA 3.02(B) (Supp. 1975). It was long considered unwise to include these purposes in the charter because they invoked the jurisdiction of the Banking Commission under TEX. REV. CIV. STAT. art. 1524a (1962). Although this statute was repealed in 1967, it is still better practice to omit a real-estate dealing or securities-dealing purpose if this is to be only an incidental activity. Inclusion in the articles might make the corporation a dealer for tax purposes, thereby defeating its opportunity for capital gain treatment on securities sold. If a lending purpose is stated, it must be qualified by adding "without banking and discounting privileges" since banks may not be organized under TBCA. See Lake, *Check List for Corporate Names and Purposes Clauses Under TBCA*, 23 TEX. B.J. 827 (1960).

(D) A purpose to act as trustee is considered impermissible under the TBCA although it may be proper for a bank or trust company. A purpose to write bail bonds is considered impermissible under the TBCA although it may be proper for an insurance company. Insurance agency purposes must conform to Insurance Code language, e.g., "to act as a local recording agent" or "to act as a managing general agent." Accounting and auditing purposes are barred by the licensing laws for that profession. All these points are covered in FILING GUIDE 9.

9. The last sentence is optional. If different classes of shares are authorized, they must be described in detail. TBCA 3.02(A)(4)-(6) (Supp. 1975). See also TBCA 2.12 (1956); TBCA 2.13 (Supp. 1975). For an example of preferred stock provisions see text accompanying note 271 *infra*. Normally, it is best to have only one class of stock with a low par value and a large number of authorized shares, but the number and kind of shares will depend on the company's financing plans. For implementation see text accompanying notes 188-208 *infra*. See 23 SW. L.J. 827-28. On the choice between par and no-par shares see *id.* 831-32. For directors' authority to issue shares see note 137 *infra* and accompanying text.

10. This minimum capital for starting business is required by TBCA 3.02(A)(7), 3.05 (Supp. 1975). See also TBCA 2.41(A)(5) (1956). It has nothing to do with the amount economically necessary to launch the business, which will often be much higher. But it is rarely advisable to write the economic figures into the legal documents. See 23 SW. L.J. 832-33. For implementation of the legal minimum capital see notes 197, 198 and 209 *infra* and accompanying text.

tion of the value of one thousand dollars (\$1,000), consisting of money, labor done or property actually received.

6. REGISTERED OFFICE AND AGENT.¹¹ The post office address of the initial registered office of the corporation is 1000 Texas Street, Dallas, Texas 75200, and the name of its initial registered agent at such address is Arthur A. Adams.

7. INITIAL DIRECTORS.¹² The number of directors constituting the initial board of directors is three (3), and the names and addresses of the persons who are to serve as directors until the first annual meeting of the shareholders, or until their successors are elected and qualified are:

<i>Name</i>	<i>Address</i>
Arthur A. Adams	1000 Texas St., Dallas, Texas 75200
Bernard B. Brooks	1000 Texas St., Dallas, Texas 75200
Charles C. Carnes	1000 Texas St., Dallas, Texas 75200

11. (A) Specification of the office and agent are required by TBCA 2.09 (1956). A street address or building name should normally be stated except in very small towns. FILING GUIDE 9-10, 18. Office and agent may be changed pursuant to TBCA 2.10, 2.10-1 (Supp. 1975). Process, notices and demands against the corporation may be served on the agent, as well as on presidents and vice-presidents. TBCA 2.11(A) (1956). If an agent is not maintained, or cannot be found, service may be had on the secretary of state. TBCA 2.11(B).

(B) Any individual may be the agent, or any corporation which has a purpose clause to act as a registered agent. Partnerships and other corporations are not acceptable to the secretary of state. FILING GUIDE 10. The registered office may be anywhere in the state where the agent is located. Some companies designate an officer or employee and the main office, but changes in assignments or locations, made without thought of the legal consequences may lead to lost papers and default judgments. Consequently, it is safer to use the company's attorney or a corporation service company as the corporation's agent.

(C) The registered office fixes the corporation's residence for venue purposes. Ward v. Fairway Operating Co., 364 S.W.2d 194 (Tex. 1963). See 23 Sw. L.J. 833-34.

12. (A) The 1973 TBCA amendments changed the minimum number of directors from three to one. TBCA 2.32 (Supp. 1975).

(B) Only the number of initial directors need be specified in the articles. The number thereafter may be stated in the articles, or left to the bylaws, or to a procedure set out in the articles or bylaws. See Bylaw 3.02; notes 46, 86 *infra*.

(C) A one-person board creates tremendous temptations for conflict of interest (unless the director is the sole shareholder), carries heavy responsibility for decision making (see TBCA 2.31 (1956)) and may produce awkward gaps on absence, disability or death of the director. On the other hand, it dispenses with needless formal plurality when there is really only a single decision maker in the business. Normally, a one-person board should be used only in this instance and even then with caution if there is more than one shareholder.

(D) A two-person board also carries heavy responsibility for decision making, and can easily be paralyzed by absence, disability or death of a member or, more importantly, by simple disagreement. The tie-breaking provisional director appointed by a court for a "close corporation" under TBCA 2.30-4 (Supp. 1975) can resolve deadlocks, but this is a cumbersome process which might be unnecessary if there were three directors to begin with.

(E) In addition to the above considerations there is some advantage in having a sufficiently large board of directors to offer some diversity of input, outlook and experience.

(F) If the articles provide for shareholder management of the company (see note 21 *infra* and accompanying text; note 85(B) *infra*) or there is a shareholders' agreement for management (see note 57 *infra* and accompanying text; note 85(C) *infra*) the directors have no significant function, and there is no compelling reason to have a large or small number.

(G) Minutes of director action are required regardless of the number of directors. TBCA 2.44 (Supp. 1975).

8. INCORPORATORS.¹³ The names and addresses of the incorporators are:

<i>Name</i>	<i>Address</i>
Arthur A. Adams	1000 Texas St., Dallas, Texas 75200
Bernard B. Brooks	1000 Texas St., Dallas, Texas 75200
Charles C. Carnes	1000 Texas St., Dallas, Texas 75200

Each is age eighteen years or more and at least two are citizens of Texas.

B. Major Optional Provisions

9. PRE-EMPTIVE RIGHTS.¹⁴ No shareholder or other person shall have any pre-emptive right whatsoever.

10. BYLAWS.¹⁵ The initial bylaws shall be adopted by the Board of Directors. The power to alter, amend, or repeal the bylaws or adopt new by-

13. (A) This provision satisfies TBCA 3.01 (1956). The incorporators are not required to be directors, shareholders, or persons otherwise connected with the company. Consequently, in practice the incorporators are often three individuals selected at random in the office of the lawyer drafting the articles or the corporation service company filing them. However, these incorporators must be three or more in number, all individuals, and at least two of them Texas citizens. In contrast, some states provide that one incorporator is sufficient and that corporations, partnerships, and other entities may be incorporators. See *Incorporators*, 27 CORP. J. 171 (Dec. 1974-Feb. 1975). TBCA 3.01 (1956) still specifies that incorporators be at least 21 years old, but it has been superseded or amended by TEX. REV. CIV. STAT. ANN. art. 5923b (Supp. 1975) which reduced the age of majority from 21 to 18. See FILING GUIDE 10.

(B) If the articles of incorporation contain a close corporation shareholders agreement (see note 57 *infra* and accompanying text; 85(C) *infra*), all the prospective shareholders must be incorporators. TBCA 2.30-2(B) (Supp. 1975).

(C) Until 1973 the incorporators' only function was to call the organizational meeting of directors. Now, since the named directors can do this, the incorporators' only duty is to sign the articles of incorporation. See TBCA 3.06 (1956).

14. (A) With certain exceptions (see note 31 *infra* and accompanying text), pre-emptive rights of existing shareholders to buy additional shares issued by the company are granted unless limited or denied by the articles of incorporation. TBCA 2.22-1 (Supp. 1975). If pre-emptive rights different from those created by the statute are desired, they should be detailed in the articles. See generally HAMILTON § 759.

(B) A denial or limitation of pre-emptive rights must be stated or referenced on the stock certificates. See TBCA 2.19(B) (Supp. 1975); note 258 *infra* and accompanying text. The denial of pre-emptive rights is desirable from management's point of view in that it facilitates future financing through the sale of securities (e.g., through an underwriter or in a negotiated private placement) without first having to offer them to existing shareholders. It is almost essential to deny pre-emptive rights in a publicly held company.

(C) Considering their economic and balance-of-control value, closely held companies may want to preserve or enlarge the pre-emptive rights given by TBCA 2.22-1 (Supp. 1975). Alternatively, a closely held company may authorize only the number of shares it proposes to issue immediately. In this case the issuance of additional shares will require amendment of the articles by shareholder vote and thus will give the shareholders some control over the disposition of the new shares. Depending on the distribution of shares and the composition of the board of directors (who normally determine the price and method of sale), this procedure may approximate pre-emptive rights.

(D) Denial of pre-emptive rights in the articles does not prohibit a buy-sell agreement among shareholders or between shareholders and the company. Nor does it prevent the equivalent of pre-emptive rights by contract in favor of holders of debt securities. See note 393 *infra* and accompanying text.

15. The first sentence follows TBCA 2.23 (Supp. 1975). The second sentence is the normal pattern contemplated by TBCA 2.23 (Supp. 1975). However, the latter permits the articles of incorporation to give the shareholders all power over the bylaws, thereby excluding the directors from this critical area. Normally the directors should have power over the bylaws, since shareholders will be sufficiently protected by their statutory power to overrule the directors. An intermediate pattern, to assure shareholder

laws is vested in the Board of Directors, subject to repeal or change by action of the shareholders.

11. NUMBER OF VOTES.¹⁶ Each share has one vote on each matter on which the share is entitled to vote.

12. MAJORITY VOTES.¹⁷ A majority vote is sufficient for any action which requires the vote or concurrence of shareholders.

Alternate 12. 80% VOTES.¹⁸ Eighty per cent (80%) of the votes of outstanding shares entitled to vote is necessary for merger, consolidation, dissolution, amendment of the articles of incorporation, or amendment of the by-laws.

13. NON-CUMULATIVE VOTING.¹⁹ Directors shall be elected by majority vote. Cumulative voting shall not be permitted.

review of bylaw amendments is to let the directors make changes which become effective only on approval by a majority, or other specified fraction, of shareholders. A set of bylaws, with variations, is given below. For the adoption process see text accompanying note 175 *infra*.

16. (A) Multiple or fractional votes per share are permitted if specified in the articles of incorporation. TBCA 2.29(A)(1)(a) (Supp. 1975).

(B) If there is at least one class of voting shares, other classes may be made non-voting, except on certain matters on which all shares vote. See note 28 *infra*. However, the New York Stock Exchange normally prohibits nonvoting common stock in companies whose securities are listed on that exchange. N.Y. STOCK EXCHANGE COMPANY MANUAL A-280 (1969). And many state securities commissioners oppose or prohibit the public sale of nonvoting common stock. See, e.g., 10 CAL. ADMIN. CODE ch. 3, rule 260.140.1, CCH BLUE SKY L. REP. ¶ 8617 (1967).

(C) Multiple votes and nonvoting shares can significantly weight the balance of power among classes of shareholders.

17. (A) By TBCA 9.08 (Supp. 1975) this clause permits a simple majority of the shareholders to merge, dissolve, amend the articles of incorporation, and take other action which would otherwise require a two-thirds vote of the shareholders under TBCA 5.03(B), 6.03(A)(3), 4.02(A)(3) (Supp. 1975). The particular statute should be read in conjunction with the articles to determine (1) whether the fraction is a fraction of all outstanding shares or a fraction of those present when there is a quorum, and (2) which shares are entitled to vote on the matter. Neither of these points is covered by this provision, which does nothing more than set the relevant fraction.

B) A simple majority vote, rather than a higher fraction, facilitates major transactions and may reduce proxy soliciting expense, but it also permits a relatively small majority to dominate a large minority. Accordingly, this provision's probable effect in a particular corporation should be carefully considered before including it to override the two-thirds vote specified by the TBCA for major corporate actions.

18. (A) TBCA 9.08 (Supp. 1975) and TBCA 2.28 (1956) permit the articles to set the vote as high as desired, even 100%. The matters subject to the higher fraction either should be specified, or the clause "all matters on which shareholders are entitled to vote" should be inserted.

(B) The higher the fraction set by the articles, the smaller the minority that is given a veto power. Thus, an 80% requirement lets any 21% shareholder, or coalition of shareholders, block corporate action. It follows that the higher the fraction, the greater the possibility of deadlock, either through legitimate self-protection or less legitimate obstructionism by the minority.

For this reason, and because holdings may change over time, large fractional voting requirements should be used with caution. See also note 297(B) *infra*.

(C) If a higher fraction is required for bylaw amendment, Bylaw 8.09 should be conformed.

19. As originally enacted in 1955, TBCA 2.29(D) specified cumulative voting for all corporations unless expressly denied in the articles of incorporation. Ch. 64, art. 2.29(D), [1955] Tex. Laws 255-56 (amended 1957). An amendment to this provision, enacted in 1957, reversed this pattern for corporations organized after its effective date, August 21, 1957, denying cumulative voting unless expressly authorized in the articles. Ch. 54, § 4A, [1957] Tex. Laws 113 (amended 1964). A 1961 amendment, which became effective June 1, 1964, restored the original pattern for all corporations, apparently

Alternate 13. CUMULATIVE VOTING.²⁰

(1) At each election of directors, every shareholder entitled to vote at such election has the right: (a) to vote the number of voting shares owned by him for as many persons as there are directors to be elected (and for whose election he has a right to vote); or (b) to cumulate his votes by giving one candidate as many votes as the number of such directors multiplied by the number of his shares shall equal, or by distributing such votes on the same principle among any number of such candidates.

(2) A shareholder who intends to cumulate his votes shall give written notice of such intention to the secretary of the corporation on or before the day preceding the election at which such shareholder intends to cumulate his votes.

(3) All shareholders may cumulate if any shareholder gives such notice.

14. SHAREHOLDER MANAGEMENT.²¹ So long as the corporation is

regardless of the date of incorporation. TEX. BUS. CORP. ACT ANN. art. 2.29(D) (1964), as amended, TBCA 2.29(D) (Supp. 1975). This provision essentially has been retained by the 1973 amendments. TBCA 2.29(D) (Supp. 1975). This history of oscillation dictates that the articles always contain a provision on cumulative voting, either expressly denying or affirming the procedure. Denial of cumulative voting is usually preferred by management and major shareholders, since a more homogeneous and congenial board is likely to result. See 23 Sw. L.J. 839-40.

See generally HAMILTON § 491; Annot., *Construction, Application and Effect of Constitutional Provisions or Statutes Relating to Cumulative Voting of Stock for Corporate Directors*, 43 A.L.R.2d 1322 (1955).

20. (A) TBCA 2.29(D) (Supp. 1975) so provides unless cumulative voting is denied in the articles of incorporation. See note 19 *supra*.

(B) Cumulative voting is unnecessary and should not be permitted if the company is a "close corporation" which either provides for shareholder management or has a shareholders agreement for the election of directors. See notes 21(A), 57 *infra* and accompanying text; notes 85(B), (C) *infra*.

(C) Cumulative voting does not always assure minority representation on the board. It is affected by shifting holdings of shares, the number of directors being elected, the number of shares voting, and a misunderstanding of its mathematics and mechanics. Better representation of a well defined minority usually can be achieved by issuing several classes of stock. For example, if A and B are to have 30% and 70% of the shares and want guaranteed positions on the board, it is usually easier to provide in the articles for two classes of common stock, with Class A, sold to A, entitled to elect one director, and Class B, sold to B, the remaining directors. In all other respects the rights of the shares, such as dividends, would be identical.

21. (A) A corporation may be managed by its shareholders provided that: (1) the corporation is a "close corporation"; and (2) the shareholder management is stated on the stock certificates. TBCA 2.30-1(B) (Supp. 1975). See note 247(L) *infra*. A "close corporation" is defined as one which: (1) has no more than 15 shareholders; (2) restricts the transfer of its shares; and (3) has issued its shares without any public offering, solicitation, or advertisement. TBCA 2.30-1(A) (Supp. 1975). Cf. note 189 (B) *infra*. When the corporation is managed by its shareholders, the TBCA provisions referring to directors become applicable to the shareholders and the shareholders are subject to the liabilities of directors. TBCA 2.30-1(B) (Supp. 1975). See note 85(B) *infra*.

(B) Shareholder management is designed to integrate ownership and control, as in a partnership, and to abolish the traditional split-level corporate hierarchy in which the shareholders elect directors, and the directors manage the company. Shareholder management (though long permitted for churches, Texas Non-Profit Corporation Act § 2.14 (c), TEX. REV. CIV. STAT. ANN. art. 1396-2.14(C) (1962) is relatively unfamiliar in the business world, and may puzzle those who deal with the company expecting traditional structure and formality. For example, in a financing or property transaction, the corporation will probably be required to deliver a copy of the articles of incorporation and a shareholder resolution, when a director's resolution would suffice for an ordinary corporation.

(C) As the number of shareholders approaches the limit of 15, the size of the man-

a close corporation (as defined in the Texas Business Corporation Act), its business and affairs shall be managed by the shareholders (with the votes per share, quorum, proxy, majority and other provisions applicable to shareholder meetings or actions) rather than by a board of directors.

15. OPTIONAL DISSOLUTION.²² So long as the corporation is a close

agement group will become cumbersome. Consequently, it may be wise to use this provision only when the number of shareholders is expected to be 5 or fewer.

(D) This provision is in some ways an alternative to a 1- or 2-person board of directors. See note 12 *supra*.

(E) This provision may be supplemented by a shareholders agreement on how the management rights will be exercised. An agreement of this nature may require the shareholders to vote for certain persons as officers (with certain powers, compensation and tenure) or to declare dividends of all profits. See note 57 *infra* and accompanying text; note 85(C) *infra*. Alternatively, a shareholders agreement can be a partial substitute for this provision, specifying that certain persons are officers (with certain powers, compensation and tenure) or that all profits will be distributed as dividends. However, no agreement can anticipate every management decision so there will inevitably be some scope for new decision making by the managers, whether they are directors or shareholders.

(F) Although the TBCA is not explicit on the point, it seems to contemplate that the authority of the shareholder managers will be proportional to the votes of their shares, and will be exercised in accordance with the proxy, quorum and other provisions (in the TBCA, articles, or bylaws) for shareholder meetings or for actions without meetings. Although this is made explicit in the parenthetical clause of this section of the articles and in note 85(B) *infra*, it could be spelled out in greater detail. For discussion and an alternative clause see HAMILTON § 697, at n.98.

(G) Shareholder management, with votes proportional to the number of shares held, is distinct from statutory partner management. See, e.g., UNIFORM PARTNERSHIP ACT § 18(e) [hereinafter cited as UPA] (partners have equal rights; action is authorized by a majority of the partners). Rather, shareholder management is similar to many partnership agreements which specify votes in proportion to income shares or capital accounts.

(H) It is unclear whether the articles could vest management in one class of shareholders and not another, but the result can probably be approximated by having one class of voting shares and other classes of nonvoting shares. This, of course, would be inapplicable on matters such as mergers for which all shares vote. See note 28 *infra*.

(I) Minutes are required of shareholders acting as managers. TBCA 2.44. But there need not be separate minutes for directors and for shareholders since there are, at least in effect, no directors. Informal shareholder action may have legal effect even without minutes. TBCA 2.30-1(B)(3) (Supp. 1975); note 161(B) *infra*.

(J) There are statutory provisions for electing a board of directors if the company ceases to be a "close corporation," and thereby impliedly ceases to be eligible for shareholder management. TBCA 2.30-1(C) (Supp. 1975). However, the specified procedures are slow (as long as four months) and apparently do not cover all possible ways of losing "close corporation" status. To avoid the legal limbo which may result, more comprehensive and speedy provisions may be inserted in the articles. Alternatively, a board of directors may be elected periodically to stand by until needed.

22. (A) TBCA 2.30-5(B) (Supp. 1975) permits this and many other varieties of optional dissolution of a "close corporation" provided that they are stated or referenced on the stock certificates. Other methods of optional dissolution include: (1) by a specified proportion of shares rather than by any holder; and (2) on events which may be specified in the articles such as death, retirement, deadlock (which needs definition), failure to pay dividends or salaries at a prescribed level, breach of the shareholders agreement, or failure of the company or other shareholders to purchase shares when offered to them. An optional dissolution provision must be stated or referenced on the stock certificates. See note 247(O) *infra*.

(B) The quoted provision makes the corporation as easy to dissolve as a partnership at will. See UPA § 31(1)(b). This provision will protect the shareholder who is locked into an unprofitable or oppressive relationship. But, as in partnership, dissolution is no panacea. To be economically useful, this provision should be supported by an agreement delineating the disposition of the elements of value of the business. For example, an agreement could specify public sale (perhaps under court supervision) of the assets along with continued use of company name, records, location, employees, etc. Failure to make an arrangement of this nature could cause the dissolving shareholder to realize little or nothing for his interest.

(C) The protective purposes of easy dissolution can often be better achieved through

corporation (as defined in the Texas Business Corporation Act), it may be dissolved at any time by any shareholder giving written notice to the other shareholders in accordance with the Texas Business Corporation Act.

16. INTERESTED DIRECTORS, OFFICERS AND SECURITY HOLDERS.²³

(A) *Validity.* If paragraph (B) is satisfied, no contract or other transaction between the corporation and any of its directors, officers or security holders, or any corporation or firm in which any of them are directly or indirectly interested, shall be invalid solely because of this relationship or because of the presence of the director, officer or securityholder at the meeting authorizing the contract or transaction, or his participation or vote in the meeting or authorization.

(B) *Disclosure, Approval; Fairness.* Paragraph (A) shall apply only if:

(1) the material facts of the relationship or interest of each such director, officer or securityholder are known or disclosed:

(a) to the Board of Directors and it nevertheless authorizes

a buy-sell agreement which preserves the continuity values of the business and provides the outgoing member with a fair price for his interest (*e.g.*, by capitalization of earnings or by appraisal). This is particularly true at death or retirement.

(D) It seems reasonably clear that dissolution of the company under a provision of this kind terminates, without liability, any shareholders' agreement concerning the company, except post-dissolution (winding up) provisions of the agreement. Nonetheless, it may be desirable to specify—in the articles, the agreement, or both—that dissolution has this effect.

23. (A) This provision is without express statutory authority.

(B) Conflict-of-interest transactions are valid without a charter provision if they are: (1) fundamentally fair; (2) fully disclosed to the shareholders; and (3) approved by the shareholders. See *Western Inn Corp. v. Heyl*, 452 S.W.2d 752 (Tex. Civ. App.—Fort Worth 1970), *error ref. n.r.e.*; *Wiberg v. Gulf Coast Land & Dev. Co.*, 360 S.W.2d 563 (Tex. Civ. App.—Beaumont 1962), *error ref. n.r.e.* How much farther one may go with a charter provision is unclear; thus the efficacy of this provision is not beyond doubt. See *Reynolds-Southwestern Corp. v. Dresser Indus., Inc.*, 438 S.W.2d 135 (Tex. Civ. App.—Houston [14th Dist.] 1969), *error ref. n.r.e.* (saying that contracts between corporations with common directors are disfavored, but holding that fairness and good faith are determinative); *HAMILTON* § 724. See also *Stockton v. Lake Tanglewood & Skybolt, Inc.*, 441 S.W.2d 575 (Tex. Civ. App.—Amarillo 1969) (transfer from corporation to director cancelled for unfairness and lack of consideration; other directors apparently were unaware of the transfer). See generally *Lebowitz, Director Misconduct and Shareholder Ratification*, 6 BAYLOR L. REV. 1 (1953).

(C) Perhaps a provision like this merely shifts to a plaintiff shareholder the burden of proving the transaction unfair (without the provision, the director, etc., would have the burden of showing fairness). See Comment, *The Interested Director in Texas*, 21 Sw. L.J. 794, 805 (1967) (so concluding after a review of Texas conflict cases).

(D) Validation of conflict-of-interest transactions is almost essential if the management or major shareholders have diversified interests (or want to deal with the corporation), or if the corporation hopes to attract outside directors with such interests. But there is great potential for unfairness if the interested directors or officers possess or control sufficient shares to assure shareholder approval. A more equitable provision would be to modify (B)(1)(b) to require approval by a majority of the *disinterested* shares. But this is rarely done, partly because of the difficulty in identifying disinterested shares (*e.g.*, how to treat relatives, friends, associates of the interested persons) and partly because the clients dislike this approach.

(E) Although this provision is often left to the bylaws, it has greater force if included in the articles of incorporation. See 23 Sw. L.J. 845. For a similar provision in a statute see DEL. CODE ANN. tit. 8, § 144 (1975); MODEL BUSINESS CORPORATION ACT § 41 (1974). For an even broader provision see 1A W. FLETCHER, CORPORATE FORMS ANNOTATED 462, § 1394.1 (1957). See also W. CARY, CASES AND MATERIALS ON CORPORATIONS 552-94 (4th ed. unabridged, 1969); G. SEWARD, BASIC CORPORATE PRACTICE 131-32 (1966).

or ratifies the contract or transaction by a majority of the directors present, each such interested director to be counted in determining whether a quorum is present but not in calculating the majority necessary to carry the vote; or

(b) to the shareholders and they nevertheless authorize or ratify the contract or transaction by a majority of the shares present, each such interested person to be counted for quorum and voting purposes; or

(2) the contract or transaction is fair to the corporation as of the time it is authorized or ratified by the Board of Directors, or the shareholders.

(C) *Non-Exclusive*. This provision shall not be construed to invalidate a contract or transaction which would be valid in the absence of this provision.

17. INDEMNIFICATION; INSURANCE.²⁴

(A) *Persons*. The corporation shall indemnify, to the extent provided in paragraphs (B), (D) or (F):

(1) any person who is or was director, officer, agent or employee of the corporation, and

(2) any person who serves or served at the corporation's request as a director, officer, agent, employee, partner or trustee of another corporation or of a partnership, joint venture, trust or other enterprise.

(B) *Extent—Derivative Suits*. In case of a suit by or in the right of the corporation against a person named in paragraph (A) by reason of his holding a position named in paragraph (A), the corporation shall indemnify him if he satisfies the standard in paragraph (C), for expenses (including attorney's fees but excluding amounts paid in settlement) actually and reasonably incurred by him in connection with the defense or settlement of the suit.

(C) *Standard—Derivative Suits*. In case of a suit by or in the right of the corporation, a person named in paragraph (A) shall be indemnified only if:

(1) he is successful on the merits or otherwise, or

24. (A) This indemnification provision is somewhat broader than TBCA 2.02(A) (16) (Supp. 1975) which deals with the same subject. This provision is patterned after MODEL BUSINESS CORPORATION ACT § 5 (1974) and DEL. CODE ANN. tit. 8, § 145 (1975). Its validity in Texas has not been established. See HAMILTON § 731.

(B) Indemnification provisions are often left to the bylaws, but have greater force if included in the articles of incorporation. For a comprehensive treatment of the problem see G. WASHINGTON & J. BISHOP, *INDEMNIFYING THE CORPORATE EXECUTIVE* (1963) (pages 280-301 of the volume reproduce the indemnification provisions of a number of major corporations). See also W. CARY, *CASES AND MATERIALS ON CORPORATIONS* 987-1006 (4th ed. unabridged, 1969); G. SEWARD, *BASIC CORPORATE PRACTICE* 22 (Supp. 1969).

(C) Indemnification is considered vital by management of publicly held companies because of the incidence of shareholder suits and government proceedings against management. It is less essential, and perhaps less likely to produce fair results, in a closely held company.

(D) There are many variables to consider in drafting an indemnification clause, particularly: (1) whether indemnification ought to be mandatory or discretionary; (2) the standard of conduct by which the indemnitee's behavior ought to be measured (e.g., whether the indemnitee must show that he acted in good faith for the benefit of the company or whether something less, such as showing that his act was "not opposed to" the interest of the company, will suffice; (3) who should decide whether the standard has been met; and (4) what expenses are to be covered. This provision is extremely broad.

(E) Insurance is expressly authorized by TBCA 2.02(A)(16) (Supp. 1975).

(2) he acted in good faith in the transaction which is the subject of the suit, and in a manner he reasonably believed to be in, or not opposed to, the best interests of the corporation. However, he shall not be indemnified in respect of any claim, issue or matter as to which he has been adjudged liable for negligence or misconduct in the performance of his duty to the corporation unless (and only to the extent that) the court in which the suit was brought shall determine, upon application, that despite the adjudication but in view of all the circumstances, he is fairly and reasonably entitled to indemnity for such expenses as the court shall deem proper.

(D) *Extent—Nonderivative Suits.* In case of a suit, action or proceeding, (whether civil, criminal, administrative or investigative), other than a suit by or in the right of the corporation, together hereafter referred to as a nonderivative suit, against a person named in paragraph (A) by reason of his holding a position named in paragraph (A), the corporation shall indemnify him if he satisfies the standard in paragraph (E), for amounts actually and reasonably incurred by him in connection with the defense or settlement of the nonderivative suit as

- (1) expenses (including attorneys' fees),
- (2) amounts paid in settlement,
- (3) judgments, and
- (4) fines.

(E) *Standard—Nonderivative Suits.* In case of a nonderivative suit, a person named in paragraph (A) shall be indemnified only if:

- (1) he is successful on the merits or otherwise, or
- (2) he acted in good faith in the transaction which is the subject of the nonderivative suit, and in a manner he reasonably believed to be in, or not opposed to, the best interests of the corporation and, with respect to any criminal action or proceeding, he had no reason to believe his conduct was unlawful. The termination of a nonderivative suit by judgment, order, settlement, conviction, or upon a plea of *nolo contendere* or its equivalent shall not, of itself, create a presumption that the person failed to satisfy the standard of this paragraph (E)(2).

(F) *Determination That Standard Has Been Met.* A determination that the standard of paragraph (C) or (E) has been satisfied may be made by a court. Or, except as stated in paragraph (C)(2) (2d sentence), the determination may be made by:

- (1) a majority of the directors of the corporation (whether or not a quorum) who were not parties to the action, suit or proceeding, or
- (2) independent legal counsel (appointed by a majority of the directors of the corporation, whether or not a quorum, or elected by the shareholders of the corporation) in a written opinion, or
- (3) the shareholders of the corporation.

(G) *Proration.* Anyone making a determination under paragraph (F) may determine that a person has met the standard as to some matters but not as to others, and may reasonably prorate amounts to be indemnified.

(H) *Advance Payment.* The corporation may pay in advance any ex-

penses (including attorneys' fees) which may become subject to indemnification under paragraphs (A)-(G) if:

(1) the board of directors authorizes the specific payment and

(2) the person receiving the payment undertakes in writing to repay unless it is ultimately determined that he is entitled to indemnification by the corporation under paragraphs (A)-(G).

(I) *Nonexclusive.* The indemnification provided by paragraphs (A)-(G) shall not be exclusive of any other rights to which a person may be entitled by law, bylaw, agreement, vote of shareholders or disinterested directors, or otherwise.

(J) *Continuation.* The indemnification and advance payment provided by paragraphs (A)-(H) shall continue as to a person who has ceased to hold a position named in paragraph (A) and shall inure to his heirs, executors and administrators.

(K) *Insurance.* The corporation may purchase and maintain insurance on behalf of any person who holds or who has held any position named in paragraph (A), against any liability incurred by him in any such position, or arising out of his status as such, whether or not the corporation would have power to indemnify him against such liability under paragraphs (A)-(H).

(L) *Reports.* Indemnification payments, advance payments, and insurance purchases and payments made under paragraphs (A)-(K) shall be reported in writing to the shareholders of the corporation with the next notice of annual meeting, or within six months, whichever is sooner.

In witness whereof, we have hereunto set our hands this _____, 19____.

s/	Arthur A. Adams	

	Arthur A. Adams	
s/	Bernard B. Brooks	

	Bernard B. Brooks	
s/	Charles C. Carnes	25

	Charles C. Carnes	

Sworn to _____, 19____.²⁶

(NOTARY SEAL)

s/	Donna D. Davis

	Donna D. Davis
	Notary Public
	Dallas County, Texas

25. Duplicate originals are filed with the Secretary of State, Corporation Division. TBCA 3.03 (1956). The fee is \$100. TBCA 10.01(A)(1) (Supp. 1975). Payment by personal check is ordinarily accepted. On processing by the secretary of state see generally FILING GUIDE 1-10, 19-20.

26. TBCA 3.01 (1956) requires that the articles be "verified." The simple "sworn to" will satisfy the secretary of state. FILING GUIDE 10, 16, 18. A longwinded jurat is not necessary; nor is an acknowledgment. At times, acknowledgments have not been acceptable to the secretary of state.

In the Name and by the Authority of
THE STATE OF TEXAS
Office of the Secretary of State
CERTIFICATE OF INCORPORATION
OF
ABC CORP.²⁷

Charter No. 123456

The undersigned, as Secretary of State of the State of Texas, hereby certifies that duplicate originals of Articles of Incorporation for the above corporation duly signed and verified pursuant to the provisions of the Texas Business Corporation Act, have been received in this office and are found to conform to law.

ACCORDINGLY the undersigned, as such Secretary of State and by virtue of the authority vested in him by law, hereby issues this Certificate of Incorporation and attaches hereto a duplicate original of the Articles of Incorporation.

Dated _____, 19__

The State of Texas
(Seal)

s/

Secretary of State

C. *Other Optional Provisions—A Checklist*

Any other provision not inconsistent with law²⁸ may be included in the articles of incorporation.²⁹ In a number of instances, indicated in the relevant footnotes, the provisions must be included in the articles (or, in some cases, in the bylaws) in order to be effective. A checklist of these provisions follows.

18. Non-voting shares.³⁰

27. The certificate of incorporation is prepared and issued by the secretary of state. TBCA 3.03(A) (1956). Corporate existence begins at the time of issuance. TBCA 3.04 (1956). The certificate is conclusive evidence of due incorporation, except in a proceeding by the state for involuntary dissolution. TBCA 3.04 (1956). TBCA 9.04 (1956) provides a court appeal if the secretary of state refuses to issue the certificate.

28. The following rights cannot be varied by the articles of incorporation: (1) the right of all shares to vote on merger or consolidation (TBCA 5.03(B) (Supp. 1975)); (2) the right of all shares to vote on a sale of assets (TBCA 5.10(A)(3) (Supp. 1975)); (3) the right of all shares to vote on dissolution (TBCA 6.03(A)(3) (Supp. 1975)); (4) the right of a class of shares to vote as a class on an amendment to the articles of incorporation or a merger or consolidation which would make specified changes in their class of shares or in the corporation (TBCA 4.03(B) (Supp. 1975)); and (5) the right of a shareholder to dissent from a merger, consolidation, or sale of assets, and receive payment for his shares (TBCA 5.11-13 (Supp. 1975)). See HAMILTON §§ 499-500. The number of votes per share and the percentage of votes needed for approval can be modified. See notes 16-18 *supra* and accompanying text; note 297 *infra*.

29. TBCA 3.02(A)(10) (Supp. 1975). In general, these provisions may include any matters which may be in the bylaws. TBCA 3.02(A)(10) (Supp. 1975); cf. note 61 (C) *infra*. For a clause intended as relief against the corporate opportunity doctrine see Note, *Corporate Opportunity*, 74 HARV. L. REV. 765, 777 (1961). Other checklists of optional provisions for Texas articles will be found in HAMILTON § 270 and FILING GUIDE 11-14.

30. TBCA 2.29(A) (Supp. 1975) (as qualified by TBCA 4.03 (Supp. 1975) and provisions cited in note 28 *supra*).

19. Granting of pre-emptive rights: (a) as to shares issued to employees pursuant to certain plans; (b) as to shares issued otherwise than for cash; (c) to holders of preferred shares (as to any securities); (d) to holders of common shares (as to non-convertible preferred shares); and (e) to holders of non-voting common shares (as to voting common shares).³¹
20. Designation as consuming assets corporation.³²
21. Classification of directors and corresponding election of each class for two- or three-year terms.³³
22. Shareholders' right to fix consideration for no-par shares.³⁴
23. The right to pay dividends in the stock of one class to holders of stock of another class.³⁵
24. Special dividend restrictions.³⁶
25. Special redemption restrictions.³⁷
26. Shareholders' rights to authorize and dissent from mortgage or pledge of corporate assets.³⁸
27. Greater or lesser voting requirements.³⁹
28. Cumulative voting.⁴⁰
29. Greater quorum for directors.⁴¹
30. Greater quorum for shareholders.⁴²
31. Smaller quorum for shareholders.⁴³
32. Additional persons authorized to call special shareholder meetings.⁴⁴
33. Executive and other committees.⁴⁵
34. Limitations on officers' exercise of general powers.⁴⁶
35. Prohibition of the re-issue of redeemable shares after redemption or purchase.⁴⁷

31. All of these rights are denied unless expressly stated in the articles of incorporation. TBCA 2.22-1(B) (Supp. 1975). The board of directors may set the price and terms of any pre-emptive offering unless the articles provide otherwise (*e.g.*, by a formula price, or for shareholder determination of the price). *See also* note 14 *supra* and accompanying text; note 50 *infra* and accompanying text.

32. TBCA 1.02(A)(17), 2.39 (1956).

33. TBCA 2.33 (1956). This can also be done by means of bylaws. *See* Bylaw 3.02 Alternate *infra*.

34. TBCA 2.15(B) (1956).

35. TBCA 2.38(A)(4) (1956). This can also be done by majority vote of the class originally entitled to the dividend payment.

36. TBCA 2.38(A) (1956). For examples see text accompanying notes 282, 312 *infra*.

37. TBCA 4.08(A) (1956).

38. TBCA 5.09-.11(A)(2) (Supp. 1975).

39. TBCA 9.08 (Supp. 1975), 2.28 (1956) (shareholders), 2.35 (Supp. 1975) (directors). *See* note 17-18 *supra* and accompanying text.

40. TBCA 2.29(D) (Supp. 1975). *See* notes 19-20 *supra* and accompanying text.

41. TBCA 2.35 (Supp. 1975). This can also be done through bylaws. *See* notes 73, 101 *infra* and accompanying text.

42. TBCA 2.28 (1956). *See* note 73 *infra* and accompanying text.

43. TBCA 2.28 (1956). The minimum quorum permitted is one third of the shares.

44. TBCA 2.24(C) (Supp. 1975). This can also be done through bylaws.

45. TBCA 2.36 (Supp. 1975). This can also be done by means of bylaws. *See* notes 109-122 *infra* and accompanying text.

46. TBCA 2.02(B) (1956).

47. TBCA 4.10(A) (1956). *See* notes 291, 323 *infra* and accompanying text.

36. Preferred or special shares in series.⁴⁸
37. Restrictions on the transferability of shares.⁴⁹
38. Restrictions on the issuance of rights, options, and convertibles.⁵⁰
39. Restriction or denial of the power of directors or committees to act by unanimous written consent without a meeting.⁵¹
40. Restriction or denial of the power of shareholders, directors, or committees to hold telephone meetings.⁵²
41. Permission to repurchase shares by director vote (without shareholder vote) to the extent of capital or reduction surplus.⁵³
42. Restriction on the authority to repurchase shares by director vote to the extent of earned surplus.⁵⁴
43. Authority of a registered open-end investment company to repurchase shares to the extent of stated capital or any surplus.⁵⁵
44. Authority for an executive committee or other committee to declare dividends or authorize the issuance of shares.⁵⁶
45. Unanimous shareholder agreements on management of the business (by one or more shareholders, directors, or others), share transfer restrictions, voting, employment, designation of officers and directors, dividends, and arbitration.⁵⁷
46. Fixing the number of directors, or the manner in which the number may be fixed (e.g. relative to the number of shares or classes of shares outstanding, or by resolution of the directors).⁵⁸
47. Provisions for the removal of directors.⁵⁹
48. Acceptance of pre-incorporation share subscriptions by filing a list of the subscriptions with the articles of incorporation.⁶⁰

48. TBCA 2.13 (1956 & Supp. 1975). For an example see text accompanying notes 298-327 *infra*.

49. TBCA 2.22(B)-(D), 2.19(F) (Supp. 1975). This can also be done through bylaws or agreement. See note 264 *infra* and accompanying text.

50. TBCA 2.14-1 (Supp. 1975). See also note 31 *supra* and accompanying text. For examples of warrants (a form of right or option) and convertibles see text accompanying notes 328-435 *infra*.

51. TBCA 9.10(B) (Supp. 1975). This can also be done by means of bylaws.

52. TBCA 9.10(C) (Supp. 1975). This can also be done by means of bylaws.

53. TBCA 2.03(D) (Supp. 1975). If this provision is not included in the articles of incorporation, such repurchases still can be made by a two-thirds vote of the shareholders entitled to vote on the matter.

54. TBCA 2.03(C) (1956).

55. TBCA 2.03(G) (1956).

56. TBCA 2.36 (Supp. 1975). This can also be done through the bylaws. See note 109(C) *infra*; text accompanying note 112 *infra*.

57. TBCA 2.30-2(A), 2.22 (Supp. 1975). These things may also be accomplished through the bylaws. See note 85(C) *infra*.

58. TBCA 2.32 (Supp. 1975). This can also be done through the bylaws. See also note 86 *infra*.

59. TBCA 2.32 (Supp. 1975). This can also be done through the bylaws. See Bylaw 3.04.

60. TBCA 2.14(B) (1956). Failure to include a subscription in the list constitutes a rejection of that subscription offer. TBCA 2.14(B) (1956). Presumably failure to file any list constitutes a rejection of all the subscriptions, although the Act does not quite say this. See generally HAMILTON § 322. Note that the list, if filed, is not a part of the articles, but a separate document accompanying it. Subscriptions, as Hamilton discusses in some detail, are rarely used.

II. BYLAWS OF ABC CORP.⁶¹

Contents

Art. 1: Offices

1.01 Registered Office & Agent

1.02 Other Offices

61. (A) These bylaws are drafted to comply with the TBCA but the form will not vary greatly in other jurisdictions. This particular form is in large measure based on bylaws prepared by George Slover, Jr., of the Dallas Bar and on K. PANTZER & F. O'NEAL, *THE DRAFTING OF CORPORATE CHARTERS AND BY-LAWS* (1951). See also Campbell, *The Drafting of Articles of Incorporation and Bylaws Under the Texas Business Corporation Act*, 3A TEX. REV. CIV. STAT. ANN. 576 (1956). Additional and alternative forms may be found in 1A W. FLETCHER, *CORPORATION FORMS ANNOTATED* 261-474 (3d ed. rev. vol. 1957); HAMILTON §§ 276-77; H. KENDRICK & J. KENDRICK, *TEXAS TRANSACTION GUIDE—LEGAL FORMS* §§ 3.160-221(2) (looseleaf, orig. pub. 1972); K. PANTZER & R. DEER, *THE DRAFTING OF CORPORATE CHARTERS AND BYLAWS* (2d ed. 1968) (MODEL BUSINESS CORPORATION ACT); G. SEWARD, *BASIC CORPORATE PRACTICE* 145-98 (1966, Supp. 1969) (Del., N.Y., Model Act). See also C. ISRAELS, *CORPORATE PRACTICE* 193-245 (3d ed. 1974) (Del., N.Y.).

(B) These bylaws are relatively comprehensive, and are designed to suffice for a publicly held company. They may be too extensive for a closely held company. A minimal set of bylaws might contain only the material covered by Bylaws 2.01, 2.02, 3.02, 3.07-.10 and 6.01. See 5 R. STAYTON, *STAYTON'S TEXAS FORMS* § 2481 (1959). Closely held companies which qualify as "close corporations" will require other modifications of the bylaws if they choose shareholder management or shareholders agreement. See notes 85(B), (C) *infra*. For an extended treatment of the problems in other states see R. KESSLER, *NEW YORK CLOSE CORPORATIONS* ch. 13 (looseleaf, orig. pub. 1968) and, more generally, F. O'NEAL, *CLOSE CORPORATIONS* (2 vols. looseleaf 1971 & Supp. 1974).

(C) The draftsman has considerable latitude in the preparation of bylaws, because essentially they are regulations for internal corporate affairs. He may include any provision not inconsistent with law and the articles of incorporation. TBCA 2.23 (Supp. 1975). Thus, his choice between alternative forms of Bylaw 3.06 will depend on whether or not the articles of incorporation call for cumulative voting. There are few statutory requirements as to bylaw content, and most of these are in the guise of provisions specifying that a particular procedure, in order to be effective, must be either in the articles of incorporation or in the bylaws. For example see Bylaws 3.02 (qualifications of directors), 3.04 (removal of directors), and 2.07 (vote required of shareholders). See also text accompanying notes 28-60 *supra*. Other provisions are mere repetitions or paraphrases of the Act included as reminders or warnings to management which is unlikely to be intimately acquainted with the statutes. For examples see Bylaws 2.03 (voting list), 2.10 (shareholder action without meeting) and 5.02 (waiver of notice). Still other matters have no express statutory authorization and are purely optional. See, e.g., Bylaws 3.14 (interested directors), 5.01 (method of giving notice) and 6.06-.11 (duties of officers). It is customary to omit from the bylaws complicated provisions fully set forth in the articles of incorporation, such as the relative rights of classes of shares. See note 162 *infra* and accompanying text. For a fuller discussion of charter-bylaw distinctions see 23 Sw. L.J. 820 (1969).

(D) Bylaws are required by TBCA 2.23 (Supp. 1975) which provides that they shall be initially adopted by the directors. Thus, they are one of the basic structural documents of the corporation. They will be prepared by the organizing attorney, in conjunction with the articles of incorporation and security certificates, to give the corporation the character desired by its organizers. The bylaws are presented for formal adoption at the first meeting of directors. See TBCA 3.06; note 175 *infra* and accompanying text. Unlike the articles of incorporation, the bylaws are not filed for public record; they are customarily inserted in the corporate minute book and are open to shareholder inspection. TBCA 2.44 (Supp. 1975). On the power to amend the bylaws see note 15 *supra* and accompanying text and Bylaw 8.09.

(E) Broadly speaking, the bylaws are binding on the corporation and its shareholders. Because they are not public records and can be amended with comparative ease, there is considerable divergence of opinion as to the effect of the bylaws on third persons. See 8 W. FLETCHER, *PRIVATE CORPORATIONS* §§ 4197-99 (perm. ed. 1966). Any bylaw provision can be given greater force by including it in the articles of incorporation but this may create unfortunate inflexibilities. As a rule, it is preferable to insert in the articles of incorporation only those provisions which are required by statute or insisted upon by the organizers with absolute certainty; other matters are better left to the bylaws. There is an inevitable temptation to cram the bylaws with non-essential provisions

Art. 2: Shareholders

- 2.01 Place of Meetings
- 2.02 Annual Meetings
- 2.03 Voting List
- 2.04 Special Meetings
- 2.05 Notice
- 2.06 Quorum
- 2.07 Majority Vote; Withdrawal of Quorum
- 2.08 Method of Voting
- 2.09 Record Date; Closing Transfer Books
- 2.10 Action Without Meeting
- 2.11 Telephone and Similar Meetings
- 2.12 Order of Business at Meetings

Art. 3: Directors

- 3.01 Management
- 3.02 Number; Qualification; Election; Term
- 3.02 Number; Qualification; Election; Term [Alternate Form for Classified Directors]
- 3.03 Change in Number
- 3.04 Removal
- 3.05 Vacancies
- 3.06 Election of Directors
- 3.06 Election of Directors [Alternate Form for Cumulative Voting]
- 3.07 Place of Meetings
- 3.08 First Meetings
- 3.09 Regular Meetings
- 3.10 Special Meetings
- 3.11 Quorum; Majority Vote
- 3.12 Compensation
- 3.13 Procedure
- 3.14 Action Without Meeting
- 3.15 Telephone and Similar Meetings
- 3.16 Interested Directors, Officers, and Shareholders

Art. 4: Executive Committee

- 4.01 Designation
- 4.02 Number; Qualification; Term
- 4.03 Authority
- 4.04 Change in Number
- 4.05 Removal
- 4.06 Vacancies
- 4.07 Meetings
- 4.08 Quorum; Majority Vote

of dubious value, especially those protective of management. Any such provision, of course, creates some rigidity even though bylaws are easier to amend than articles of incorporation.

- 4.09 Compensation
- 4.10 Procedure
- 4.11 Action Without Meeting
- 4.12 Telephone and Similar Meetings
- 4.13 Responsibility

Art. 5: Notice

- 5.01 Method
- 5.02 Waiver

Art. 6: Officers & Agents

- 6.01 Number; Qualification; Election; Term
- 6.02 Removal
- 6.03 Vacancies
- 6.04 Authority
- 6.05 Compensation
- 6.06 President
- 6.07 Vice President
- 6.08 Secretary
- 6.09 Assistant Secretary
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Art. 7: Certificates and Shareholders

- 7.01 Certificates
- 7.02 Issuance
- 7.03 Payment for Shares
- 7.04 Subscriptions
- 7.05 Lien
- 7.06 Lost, Stolen or Destroyed Certificates
- 7.07 Registration of Transfer
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- 7.09 Pre-Emptive Rights

Art. 8: General Provisions

- 8.01 Dividends and Reserves
- 8.02 Books and Records
- 8.03 Annual Statement
- 8.04 Checks and Notes
- 8.05 Fiscal Year
- 8.06 Seal
- 8.07 Indemnification
- 8.08 Resignation
- 8.09 Amendment of Bylaws
- 8.10 Construction
- 8.11 Table of Contents; Headings
- 8.12 Relation to Articles of Incorporation

Article 1: Offices

1.01 *Registered Office & Agent.* The registered office of the corporation shall be at 1000 Texas Street, Dallas, Texas. The name of the registered agent at such address is Arthur A. Adams.⁶²

1.02 *Other Offices.* The corporation may also have offices at such other places both within and without the State of Texas as the board of directors may from time to time determine or the business of the corporation may require.⁶³

Article 2: Shareholders

2.01 *Place of Meetings.* Meetings of shareholders shall be held at the time and place,⁶⁴ within or without the State of Texas, stated in the notice of the meeting or in a waiver of notice.⁶⁵

2.02 *Annual Meetings.* An annual meeting⁶⁶ of the shareholders shall be held each year at 10 a.m. on a day during the month of April to be selected by the board of directors.⁶⁷ If such a day is a legal holiday, then the meeting shall be on the next business day following. At the meeting, the shareholders shall elect directors and transact such other business as may properly be brought before the meeting.

2.03 *Voting List.* At least ten days before each meeting of shareholders, a complete list of the shareholders entitled to vote at the meeting, arranged

62. A domestic corporation must maintain a registered agent at a registered office in Texas. TBCA 2.09 (1956). (So must a qualified foreign corporation. TBCA 8.08 (1956)). See note 11 *supra* and accompanying text. Neither the office nor the agent need be specified by the bylaws, but this may be the best way for the corporation to record them. Any change requires a filing with the secretary of state, but this is sufficient if supported by resolution of the directors. TBCA 2.10 (1956 & Supp. 1975). If a Texas corporation is required to maintain offices or agents in other states, these may also be listed in the bylaws. The disadvantage of listing offices (especially the registered office) or agents in the bylaws is the technical need for amendments of the bylaws each time a change is made.

63. Corporations may have offices inside and outside the state. TBCA 2.02(A) (11) (Supp. 1975). A bylaw is not necessary to establish other offices, but compliance with the qualification laws of the jurisdictions where such offices are located is necessary.

64. Shareholder meetings may be held at the place stated in or fixed in accordance with the bylaws. If no place is prescribed, the meetings must be at the registered office. TBCA 2.24(A) (Supp. 1975). All the bylaw meeting provisions are subject to Bylaws 2.10 and 2.11 and presumably to any "close corporation" shareholders agreement. See note 85(C) *infra*. See generally HAMILTON § 443.

65. Notice may be waived either before or after the meeting. TBCA 9.09 (1956); Bylaw 5.02.

66. Corporations are required to have annual meetings. TBCA 2.24(B) (Supp. 1975). However, only voting shareholders are entitled to receive notice. TBCA 2.25 (1956); Bylaw 2.05. As to whether a share is entitled to vote see note 78 *infra* and accompanying text. See also note 28 *supra*; HAMILTON § 443.

67. It is more common for the bylaws to state a specific date, for example the 15th day or the 3rd Monday in a particular month, but the form suggested here is more flexible. The date should be far enough after the close of the fiscal year (see Bylaw 8.05; text accompanying note 219 *infra*) that annual financial statements will be available at the meeting. An early date should be initially inserted if it is desired to classify directors, because this cannot be done before the first annual meeting. TBCA 2.33 (1956); Bylaw 3.02 (alternate). If the directors fail or refuse to call an annual meeting at the designated time, any shareholder can sue to compel the holding of a meeting. TBCA 2.24(B) (Supp. 1975).

in alphabetical order, with the address of each and the number of voting shares held by each, shall be prepared by the officer or agent having charge of the stock transfer books. The list, for a period of ten days prior to the meeting, shall be kept on file at the registered office of the corporation and shall be subject to inspection by any shareholder at any time during usual business hours. The list shall also be produced and kept open at the time and place of the meeting during the whole time thereof, and shall be subject to the inspection of any shareholder during the whole time of the meeting.⁶⁸

2.04 Special Meetings. Special meetings of the shareholders, for any purpose or purposes, unless otherwise prescribed by statute or by the articles of incorporation, or by these bylaws, may be called by the president, the board of directors, or the holders of not less than one-tenth of all the shares entitled to vote at the meetings.⁶⁹ Business transacted at a special meeting shall be confined to the purposes stated in the notice of the meeting.⁷⁰

2.05 Notice. Written or printed notice stating the place, day and hour of the meeting and, in case of a special meeting, the purpose or purposes for which the meeting is called,⁷¹ shall be delivered not less than ten nor more than fifty days before the date of the meeting, either personally or by mail, by or at the direction of the president, the secretary, or the officer or person calling the meeting, to each shareholder of record entitled to vote at the meeting. If mailed, such notice shall be deemed to be delivered when deposited in the United States mail addressed to the shareholder at his address as it appears on the stock transfer books of the corporation, with postage thereon prepaid.⁷² See also Bylaws 5.01 and 5.02.

2.06 Quorum. The holders of a majority⁷³ of the shares issued and out-

68. This list is required by TBCA 2.27(A) (1956). Failure to comply has no effect on the validity of any action taken at the meeting but the officer may be personally liable. TBCA 2.27(B)-(C) (1956). See HAMILTON § 449. See also note 70(B) *infra*.

69. TBCA 2.24(C) (Supp. 1975) expressly provides that special meetings may be called by these persons. Additional persons such as the chairman of the board, or the secretary may be empowered to call meetings by so stating in the articles of incorporation or the bylaws. See HAMILTON § 443.

70. (A) TBCA 2.25 (1956) requires statement of purpose for a special meeting of shareholders. See HAMILTON § 443; note 71 *infra*.

(B) If there is to be shareholder management of a "close corporation," many of the statutory requirements for a shareholders' meeting may make little sense, and can be dilatory and cumbersome. See, e.g., TBCA 2.25 (1956), Bylaw 2.05 (minimum 10-day notice); TBCA 2.25 (1956), Bylaw 2.04 (statement of purpose of the meeting in the notice); TBCA 2.27 (1956), Bylaw 2.03 (availability of a voting list for 10 days in advance of the meeting). The notice requirements can be waived, if all shareholders consent. Presumably all these requirements can be overridden in advance by a "shareholders agreement." See note 85(C) *infra*.

71. As written, Bylaw 2.05 tracks TBCA 2.25 (1956) and presumably satisfies state law. But it falls far short of providing the information a shareholder needs to make an intelligent decision on how to vote. See note 237(A), (B) *infra*. A more enlightened and enlightening provision like this might be substituted: "Written or printed notice stating the place, day, hour and purpose(s) of the meeting, and all material information concerning the matters to be voted on, shall be delivered . . ." Specificity of disclosure might be increased by reference to the SEC proxy rules, even though not applicable. See note 237(C) *infra*.

72. TBCA 2.25 (1956) so provides.

73. (A) The articles of incorporation may prescribe any number of shares to constitute a quorum so long as it is not less than one-third of those entitled to vote at the meeting. TBCA 2.28 (1956). See generally HAMILTON §§ 450, 686.

standing and entitled to vote thereat, present in person or represented by proxy,⁷⁴ shall be requisite and shall constitute a quorum at meetings of the shareholders for the transaction of business except as otherwise provided by statute, by the articles of incorporation or by these bylaws. If a quorum is not present or represented at a meeting of the shareholders, the shareholders entitled to vote, present in person or represented by proxy, shall have power to adjourn the meeting from time to time, without notice other than announcement at the meeting, until a quorum is present or represented. At an adjourned meeting at which a quorum is present or represented, any business may be transacted which might have been transacted at the meeting as originally notified.⁷⁵

2.07 Majority Vote; Withdrawal of Quorum. When a quorum is present at a meeting, the vote of the holders of a majority of the shares having voting power, present in person or represented by proxy, shall decide any question brought before the meeting, unless the question is one on which, by express provision of the statutes, the articles of incorporation, or these bylaws, a higher vote is required in which case the express provision shall govern.⁷⁶ The shareholders present at a duly constituted meeting may continue to transact business until adjournment, despite the withdrawal of enough shareholders to leave less than a quorum.⁷⁷

2.08 Method of Voting. Each outstanding share, regardless of class, shall be entitled to one vote on each matter submitted to a vote at a meeting of shareholders, except to the extent that the voting rights of the shares of any class or classes are limited or denied by the articles of incorporation.⁷⁸ At any meeting of the shareholders, every shareholder having the right to vote may vote either in person, or by proxy executed in writing by the shareholder or by his duly authorized attorney-in-fact. No proxy shall be valid after eleven months from the date of its execution, unless otherwise provided in the proxy. Each proxy shall be revocable unless expressly provided therein

(B) Generally a high quorum protects minority interests from action taken without their knowledge but may permit them to paralyze the corporation by staying away from a meeting and depriving it of a quorum. High quorum requirements, like high voting requirements, should be used cautiously. See notes 17-18 *supra* and accompanying text. Specific notice requirements may provide protection against action taken without knowledge of the minority.

(C) If there is shareholder management of a "close corporation," the quorum level presents a special problem. See note 85(B) *infra*.

(D) If two or more classes have separate voting rights, it is advisable to specify separate quorum requirements for them (even though the percentage is the same for each), so that one group can act if it has a quorum, even though another group lacks a quorum. For an example see the preferred stock voting provisions accompanying note 295 *infra*.

74. Proxies are permitted. TBCA 2.29(C) (Supp. 1975). Treasury shares may not vote or be counted for a quorum. TBCA 2.29(B) (1956).

75. The last two sentences are without express statutory authority.

76. (A) The effect of paragraph 12 of the articles of incorporation is to make a simple majority vote of the shareholders suffice for all actions, even those on which the TBCA normally requires a two-thirds vote. See note 17 *supra*.

(B) A higher proportion, even unanimity, can be required by appropriate provision in the articles or bylaws. See notes 17-18, 73(B) *supra* and accompanying text.

77. This provision is without express statutory authority. See HAMILTON § 450(2).

78. Voting rights may be limited or enlarged by the articles of incorporation except in certain instances. See TBCA 2.29(A) (Supp. 1975); note 16 *supra* and accompanying text; note 28 *supra*.

to be irrevocable and unless otherwise made irrevocable by law.⁷⁹ Each proxy shall be filed with the secretary of the corporation prior to or at the time of the meeting. Voting for directors shall be in accordance with Section 3.06 of these bylaws. Any vote may be taken by voice or by show of hands unless someone entitled to vote objects, in which case written ballots shall be used.⁸⁰

2.09 Record Date; Closing Transfer Books. The board of directors may fix in advance a record date for the purpose of determining shareholders entitled to notice of or to vote at a meeting of the shareholders, the record date to be not less than ten nor more than fifty days prior to the meeting; or the board of directors may close the stock transfer books for such purpose for a period of not less than ten nor more than fifty days prior to such meeting.⁸¹ In the absence of any action by the board of directors, the date upon which the notice of the meeting is mailed shall be the record date.⁸²

2.10 Action Without Meeting. Any action required by statute to be taken at a meeting of the shareholders, or any action which may be taken at a meeting of the shareholders, may be taken without a meeting if a consent in writing, setting forth the action so taken, shall be signed by all of the shareholders entitled to vote with respect to the subject matter thereof and such consent shall have the same force and effect as a unanimous vote of the shareholders.⁸³ The signed consent, or a signed copy shall be placed in the minute book.

2.11 Telephone and Similar Meetings. Shareholders, directors and committee members may participate in and hold a meeting by means of conference telephone or similar communications equipment by means of which all persons participating in the meeting can hear each other. Participation in such a meeting shall constitute presence in person at the meeting, except where a person participates in the meeting for the express purpose of objecting to the transaction of any business on the ground that the meeting is not lawfully called or convened.⁸⁴

79. TBCA 2.29(C) (Supp. 1975). Proxies irrevocable by law include those given as security (e.g., for the payment of a loan or the performance of an agreement) or coupled with an interest in the shares (e.g., to a purchaser or pledgee). See HAMILTON §§ 527, 672; Thomas, *Irrevocable Proxies*, 43 TEXAS L. REV. 733 (1965).

80. This is designed to streamline proceedings in small meetings. In large meetings written ballots are almost always necessary.

81. The directors may fix a record date not less than ten nor more than fifty days prior to the meeting or they may close the transfer books for not less than ten nor more than fifty days. TBCA 2.26 (1956).

82. TBCA 2.26 (1956) so prescribes. See HAMILTON § 472.

83. TBCA 9.10 (Supp. 1975). This provision is desirable in closely held companies. See HAMILTON § 453. Informal action without meeting is recognized in some instances. *Sutton v. Reagan & Gee*, 405 S.W.2d 828 (Tex. Civ. App.—San Antonio 1966), *error ref. n.r.e.*; TBCA 2.30-1(B)(3) (Supp. 1975) (for "close corporation").

84. Telephone and similar meetings are permitted unless restricted by the articles of incorporation or bylaws. TBCA 9.10(C) (Supp. 1975). This provision affirmatively authorizes them, to eliminate doubts. Small groups of shareholders, directors, and committee members often function well this way, but for larger groups this kind of meeting is less feasible, and less likely to produce a fully reasoned decision on complex matters. A provision of this kind should not automatically be included for larger groups, and should not automatically be used if it is included.

2.12 *Order of Business at Meetings.* The order of business at annual meetings and so far as practicable at other meetings of shareholders shall be as follows unless changed by the board of directors:

- (1) call to order
- (2) proof of due notice of meeting
- (3) determination of quorum and examination of proxies
- (4) announcement of availability of voting list (See Bylaw 2.03)
- (5) announcement of distribution of annual statement (See Bylaw 8.03)
- (6) reading and disposing of minutes of last meeting of shareholders
- (7) reports of officers and committees
- (8) appointment of voting inspectors
- (9) unfinished business
- (10) new business
- (11) nomination of directors
- (12) opening of polls for voting
- (13) recess
- (14) reconvening; closing of polls
- (15) report of voting inspectors
- (16) other business
- (17) adjournment

Article 3: Directors

3.01 *Management.* The business and affairs of the corporation shall be managed by the board of directors⁸⁵ who may exercise all such powers of

85. (A) *Director Management.* Management by directors is the general rule. TBCA 2.31 (1956).

(B) *Shareholder Management.* The articles of incorporation may provide for shareholder management of a "close corporation." See note 21 *supra* and accompanying text. If shareholder management is specified in the articles, the bylaws should be conformed. This can be done by (1) eliminating article 3 of the Bylaws (Directors) and changing "directors" or "board of directors" to "shareholders," elsewhere, or (2) leaving in all the director provisions but adding (perhaps after Bylaw 3.15) a bylaw to this effect (modelled on TBCA 2.30-1(B)(1) (Supp. 1975) and paragraph 14 of the articles of incorporation):

Shareholder Management. So long as the corporation is a close corporation (as defined in the Texas Business Corporation Act) and its affairs are to be managed by the shareholders, the shareholders shall be deemed directors for purposes of applying any of the provisions of these bylaws. The votes per share, quorum, proxy, majority and other provisions applicable to shareholder meetings or actions shall apply to shareholders in this management function.

The second alternative simplifies drafting and provides a workable set of bylaws for the directors who become necessary if the company drops or loses its "close corporation" status. See note 21(J) *supra* and accompanying text. By TBCA 2.28 (1956), the articles or bylaws can reduce to one-third the quorum for shareholders meetings. This may be too low when the shareholders are managing the company: too low for adequate protection of minorities, and too low to be consistent with the statutory scheme which requires a majority quorum for directors (TBCA 2.35) (Supp. 1975)). The draftsman would be well advised not to try to reduce the shareholder quorum in Bylaw 2.06 below a majority if the shareholders are managing the company. For the required legend on the stock certificates see note 247(L) *infra*.

(C) *Shareholders Agreement.* Whether or not the articles of incorporation provide shareholder management, TBCA 2.30-2 (Supp. 1975) permits a unanimous shareholder agreement to regulate any phase of the business and affairs of the company, including those listed below. The apparently corresponding Bylaws are also listed.

the corporation and do all such lawful acts and things as are not (by statute or by the articles of incorporation or by these bylaws) directed or required to be exercised or done by the shareholders.

3.02 Number; Qualification; Election; Term. The board of directors shall consist of three directors none of whom need be shareholders or residents of any particular state.⁸⁶ The directors shall be elected at the annual meeting

<i>Subject of Shareholder Agreement</i>	<i>Corresponding Bylaws</i>
1. Management of the business and affairs of the corporation by directors, shareholders or others	2.01-2.12 (Shareholders), 3.01-3.15 (Directors), 4.01-4.13 (Exec. Comm.), 6.01-6.11 (Officers)
2. Restriction on transfer of securities	7.07, 7.09[?]
3. Exercise or division of voting requirements or power	2.06-2.08, 3.06, 3.11, 4.08, 8.09
4. Terms and conditions of employment of any shareholder, director, officer, or employee	3.02[?], 3.04[?], 3.12[?], 4.02[?], 4.09[?], 6.01, 6.02, 6.05
5. Persons who shall be directors and officers	3.02-3.06, 4.01-4.02[?], 4.04-4.06, 6.01-6.03
6. Declaration and payment of dividends or division of profits	8.01
7. Arbitration of deadlock among shareholders or directors	—
8. Treatment of corporation as if it were a partnership	—

When using such a shareholder agreement, the draftsman has several basic choices for the bylaws: (I) write the shareholders agreement into the bylaws in lieu of the corresponding bylaws listed above, (II) write each of the corresponding bylaws as "subject to any written agreement actually assented to by all the shareholders, and filed with the corporation at its principal place of business and its registered office, so long as the corporation is a 'close corporation' (as defined in the TBCA);" (III) leave the bylaws intact but add, perhaps after Bylaw 8.12 a provision to this effect:

Shareholder Agreement. So long as the corporation is a close corporation (as defined in the Texas Business Corporation Act), these bylaws are subject to and governed by any written agreement actually assented to by all the shareholders, and filed with the corporation at its principal place of business and its registered office.

The first alternative is more precise than the other two but the latter require less drafting and, more importantly, provide residual arrangements (a) to handle matters not covered by the shareholders agreement, and (b) to operate if the company drops or loses its "close corporation" status, thereby depriving the agreement of some or all of its force. The third alternative is the simplest and perhaps therefore the most desirable. In addition, there are further requirements for the validity of a shareholders agreement (e.g., inclusion or incorporation by reference—presumably by date and specifics not here included—in the articles or bylaws) in TBCA 2.30-2(B) (Supp. 1975) and other requirements for its implementation (e.g. reference on stock certificates) in TBCA 2.30-2(C) (Supp. 1975). See note 247(M) *infra*; HAMILTON § 698. On shareholder agreements prior to the 1973 amendments see HAMILTON §§ 661-695. See also note 70(B) *supra*; notes 134(C), 150, 161(C) *infra* (on other points that need consideration in connection with a shareholders agreement).

(D) *Advisory Directors.* Some companies, especially banks, have regular management by directors and also have "advisory directors" or "honorary directors." If these are to be used, their duties, rights and responsibilities should be carefully delineated in the bylaws.

86. (A) *One- or Two-Person Boards.* See note 12 *supra* and accompanying text on the considerations in having fewer than the traditional minimum of three directors, now that there is no longer a statutory minimum. There is no statutory maximum. See generally HAMILTON § 552. If the corporation is to have a one-person board of directors most of the notice, meeting, quorum, voting and vacancy provisions of article 3 of the Bylaws become superfluous.

(B) *Changing the Number of Directors.* If the number of directors is fixed by the bylaws, as it is here, it can be changed only by amendment of the bylaws. See Bylaw 3.03. If a more flexible arrangement is desired, the bylaws can provide that the number of directors is to be fixed by resolution of the board of directors, subject to TBCA 2.32

of the shareholders, except as provided in Bylaws 3.03 and 3.05. Each director elected shall hold office until his successor shall be elected and shall qualify.⁸⁷

3.02 Number; Qualification; Election; Term [Alternate Form for Classified Directors]. The board of directors shall consist of nine directors, none of whom need to be shareholders or residents of any particular state.⁸⁸ The directors shall be classified⁸⁹ with respect to the time for which they shall severally hold office by dividing them into three classes, each consisting of three directors, and each director of the corporation shall hold office until his successor shall be elected and shall qualify. At the first annual meeting of shareholders, the directors of the first class shall be elected for a term of one year; the directors of the second class shall be elected for a term of two years; the directors of the third class shall be elected for a term of three years; and at each annual election thereafter the successors to the class of directors whose terms shall expire that year shall be elected to hold office for the term of three years, so that the term of office of one class of directors shall expire in each year.

3.03 Change in Number. The number of directors may be increased or decreased from time to time by amendment to these bylaws but no decrease shall have the effect of shortening the term of any incumbent director.⁹⁰ Any directorship to be filled by reason of an increase in the number of directors shall be filled by election at an annual meeting or at a special meeting of shareholders called for that purpose.⁹¹

3.04 Removal. Any director may be removed either for or without cause at any special or annual meeting of shareholders, by the affirmative vote of a majority in number of shares of the shareholders present, in person or by proxy, at such meeting and entitled to vote for the election of such director

(A) (Supp. 1975) (no reduction in number shortens the term of an incumbent). For other possible techniques see note 58 *supra* and accompanying text.

(C) *Qualifications for Directors.* By TBCA 2.31 (1956), the articles or bylaws may prescribe qualifications for directors, such as share ownership or Texas residence, or (to have some "outside" directors) that some *not* be officers or employees of the company. Such qualifications can lead to considerable complications. See *Popperman v. Rest Haven Cemetery, Inc.*, 341 S.W.2d 476 (Tex. Civ. App.—Waco 1960) (note to sole stockholder was unenforceable, partly because authorized by directors one of whom was not a stockholder; bylaws required all directors to be stockholders), *rev'd*, 162 Tex. 255, 345 S.W.2d 715 (1961) (non-stockholder was de facto director; unanimous stockholder consent cured defect).

87. If there are nine or more directors, they may be classified into two or three classes with staggered terms of office of two or three years. TBCA 2.33 (1956). Otherwise the term of office is one year, that is, until the next annual meeting. TBCA 2.32 (Supp. 1975). Classification tends to assure continuity (although it may be defeated by removal power) at the price of unresponsiveness to changes in share ownership. Classification has been held inconsistent with a state constitutional guarantee of cumulative voting. See *Wolfson v. Avery*, 6 Ill. 2d 78, 126 N.E.2d 701 (1955). *Contra*, *Janney v. Philadelphia Transportation Co.*, 387 Pa. 282, 128 A.2d 76 (1956). See generally HAMILTON § 494.

88. See note 86 *supra*.

89. See note 87 *supra*.

90. TBCA 2.32 (Supp. 1975) so provides. For alternative methods of changing the numbers of directors see note 86 *supra*.

91. TBCA 2.34 (1956) so provides.

if notice of intention to act upon such matter shall have been given in the notice calling such meeting.⁹²

3.05 *Vacancies.* Any vacancy occurring in the board of directors (by death, resignation, removal or otherwise) may be filled by an affirmative vote of a majority of the remaining directors though less than a quorum of the board of directors. A director elected to fill a vacancy shall be elected for the unexpired term of his predecessor in office.⁹³

3.06 *Election of Directors.* Directors shall be elected by plurality vote. Cumulative voting shall not be permitted.⁹⁴

3.06 *Election of Directors.* [Alternative Form for Cumulative Voting] [Same as Alternate ¶ 13 of Articles of Incorporation, *supra*].⁹⁵

3.07 *Place of Meetings.* Meetings of the board of directors, regular or special, may be held either within or without the State of Texas.⁹⁶

3.08 *First Meetings.* The first meeting of a newly elected board shall be held without further notice immediately following the annual meeting of shareholders, and at the same place, unless by unanimous consent of the directors then elected and serving the time or place is changed.⁹⁷

3.09 *Regular Meetings.* Regular meetings of the board of directors may be held without notice at such time and place as shall from time to time be determined by the board.⁹⁸

3.10 *Special Meetings.* Special meetings of the board of directors may be called by the president on three days' notice⁹⁹ to each director, either personally or by mail or by telegram. Special meetings shall be called by the president or secretary in like manner and on like notice on the written request of two directors. Except as otherwise expressly provided by statute, articles of incorporation, or these bylaws, neither the business to be transacted at, nor the purpose of, any special meeting need be specified in a notice or

92. (A) Removal of directors is authorized by TBCA 2.32 (Supp. 1975). See HAMILTON §§ 495, 555. The draftsman needs to balance the equities in deciding whether to make removal difficult (e.g., only for cause, perhaps with a specified procedure and burden of proof) or easy. He should inform his clients of the consequences and consider whether the provision should be in the articles of incorporation.

(B) If directors are elected by cumulative voting, they can be removed only by a higher than normal vote. See TBCA 2.32 (Supp. 1975) (last sentence of which should be inserted in the bylaws in this situation).

(C) On removal of directors elected by preferred shareholders when their dividends are in arrears see note 296 *infra* and accompanying text.

93. TBCA 2.34 (1956) so provides except that it does not specifically include vacancy by removal. The combined effect of Bylaws 3.04 and 3.05 is to let the directors fill a vacancy created when the stockholders remove a director. It might be more sound to let the stockholders fill any vacancy they create. See generally HAMILTON § 557.

94. See note 19 *supra* and accompanying text.

95. See note 19 *supra*.

96. TBCA 2.37(A) (1956). All the meeting provisions are subject to Bylaws 3.14 and 3.15.

97. TBCA 2.37(B) (1956) permits the bylaws to fix time and notice requirements.

98. The bylaws may provide that regular meetings of the board of directors shall be held without notice. TBCA 2.37(B) (1956). See HAMILTON §§ 562-63.

99. Special meetings may be called upon such notice as is prescribed by the bylaws. TBCA 2.37(B) (1956). See HAMILTON §§ 562-63.

waiver of notice.¹⁰⁰ See also Bylaws 5.01 and 5.02.

3.11 *Quorum; Majority Vote.* At meetings of the board of directors a majority¹⁰¹ of the number of directors fixed by these bylaws shall constitute a quorum for the transaction of business. The act of a majority¹⁰² of the directors present at a meeting at which a quorum is present shall be the act of the board of directors, except as otherwise specifically provided by statute, the articles of incorporation, or these bylaws. If a quorum is not present at a meeting of the board of directors, the directors present may adjourn the meeting from time to time, without notice other than announcement at the meeting, until a quorum is present.¹⁰³

3.12 *Compensation.* By resolution of the board of directors, the directors may be paid their expenses, if any, of attendance at each meeting of the board of directors and may be paid a fixed sum for attendance at each meeting of the board of directors or a stated salary as director. No such payment shall preclude any director from serving the corporation in any other capacity and receiving compensation therefor. Members of the executive committee or of special or standing committees may, by resolution of the board of directors, be allowed like compensation for attending committee meetings.¹⁰⁴

3.13 *Procedure.* The board of directors shall keep regular minutes of its proceedings.¹⁰⁵ The minutes shall be placed in the minute book of the corporation.

3.14 *Action Without Meeting.* Any action required or permitted to be taken at a meeting of the board of directors may be taken without a meeting if a consent in writing, setting forth the action so taken, is signed by all the members of the board of directors. Such consent shall have the same force and effect as a unanimous vote at a meeting. The signed consent, or a signed copy, shall be placed in the minute book.¹⁰⁶

3.15 *Telephone and Similar Meetings.* See Bylaw 2.11.¹⁰⁷

100. TBCA 2.37(B) (1956). See also Bylaws 5.01-5.02.

101. The articles or bylaws may require a greater number for a quorum. TBCA 2.35 (Supp. 1975). On the desirability of a greater number see notes 17, 18, 73 *supra*. See generally HAMILTON §§ 564, 686.

102. Vote of a greater number may be required by the articles of incorporation or bylaws. TBCA 2.35 (Supp. 1975). On the desirability of a greater number see notes 17, 18, 73 *supra*. The consequences of these provisions of TBCA 2.35 (Supp. 1975) is that each director has only one vote. By contrast to the shareholders, no provision is made for directors to vote by proxy; both the statutory implication and the cases oppose such a practice.

103. This sentence is without express statutory authority.

104. This section is without express statutory authority, although it is consistent with TBCA 2.02(A)(12) (Supp. 1975) which allows a corporation to fix the compensation of its officers and agents. For implementation see text accompanying note 220 *infra*. See also note 109(D) *infra*; HAMILTON § 554.

105. TBCA 2.44(A) (Supp. 1975) so requires.

106. TBCA 9.10(B) (Supp. 1975) permits action without a meeting unless the articles or bylaws restrict. This is usually a desirable provision. Inclusion of the consent in the minute book is not required by TBCA 2.44 (Supp. 1975) but is essential to an adequate record of corporate action. See generally HAMILTON §§ 559-60.

107. See note 84 *supra* and accompanying text.

3.16 *Interested Directors, Officers and Securityholders.* [Same as ¶ 16 of Articles of Incorporation.¹⁰⁸]

Article 4: Executive Committee

4.01 *Designation.* The board of directors may, by resolution adopted by a majority of the whole board, designate an executive committee.¹⁰⁹

4.02 *Number; Qualification; Term.* The executive committee shall consist of one or more directors, one of whom shall be the president.¹¹⁰ The executive committee shall serve at the pleasure of the board of directors.¹¹¹

4.03 *Authority.* The executive committee, to the extent provided in such resolution, shall have and may exercise all of the authority of the board of directors in the management of the business and affairs of the corporation, including authority over the use of the corporate seal. However, the executive committee shall not have the authority of the board in reference to:

- (a) amending the articles of incorporation;
- (b) approving a plan of merger or consolidation;
- (c) recommending to the shareholders the sale, lease or exchange of all or substantially all of the property and assets of the corporation otherwise than in the usual and regular course of its business;
- (d) recommending to the shareholders a voluntary dissolution of the corporation or a revocation thereof;
- (e) amending, altering, or repealing these Bylaws or adopting new Bylaws;
- (f) filling vacancies in or removing members of the board of directors or of any committee appointed by the board of directors;
- (g) fixing the compensation of any member of such committee;

108. See note 23 *supra* and accompanying text.

109. (A) Executive committees are authorized by TBCA 2.36 (Supp. 1975). For implementation by election see text accompanying notes 216-18 *infra*. See generally HAMILTON § 569.

(B) Other committees (such as Finance, Compensation or Audit) are also authorized by TBCA 2.36 (Supp. 1975) and should be included here (with specification of their authority) if desired.

(C) No committee can be given the authority listed in paragraphs (a)-(h) of Bylaw 4.03. A committee can have the authority in paragraphs (i)-(j) (declaring dividends and issuing shares) if the articles, bylaws or board resolution expressly grants it. TBCA 2.36 (Supp. 1975). Since this is highly significant authority, this bylaw reserves it to the board of directors. The bylaws may reserve other highly significant authority to the board by denying it to the executive committee (*e.g.*, electing senior officers and fixing their terms and compensation).

(D) Executive or other committees are normally advisable in only a few instances: (1) when the board is so large or scattered that it cannot function well and frequently; (2) when special expertise is needed (*e.g.*, Finance); or (3) when authority needs to be placed in outside directors to minimize conflict of interest (*e.g.*, a Compensation Committee to set salaries and stock options of officers, or an Audit Committee of the kind urged for public companies by SEC Accounting Series Release No. 123 (Mar. 23, 1972), 4 CCH FED. SEC. L. REP. ¶ 72,145). A committee to try to bypass a dissident director is likely to cause more problems than it solves.

(E) Bylaws for executive and other committees are presumably subject to any "close corporation" shareholders agreement. See note 85(C) *supra*.

110. There is no statutory requirement that the president be one of the members of the executive committee but omitting him from the committee might seriously undermine his authority as an officer.

111. Fixed terms for executive members presumably could be provided if desired.

(h) altering or repealing any resolution of the board of directors which by its terms provides that it shall not be so amendable or repealable;

(i) declaring a dividend; or

(j) authorizing the issuance of shares of the corporation.¹¹²

4.04 *Change in Number.* The number of executive committee members may be increased or decreased from time to time by resolution adopted by a majority of the whole board of directors.¹¹³

4.05 *Removal.* Any member of the executive committee may be removed by the board of directors by the affirmative vote of a majority of the whole board, whenever in its judgment the best interests of the corporation will be served thereby.¹¹⁴

4.06 *Vacancies.* A vacancy occurring in the executive committee (by death, resignation, removal or otherwise) may be filled by the board of directors in the manner provided for original designation in Bylaw 4.01.¹¹⁵

4.07 *Meetings.* Time, place and notice, (if any) of executive committee meetings shall be determined by the executive committee.¹¹⁶ See also Bylaws 5.01 and 5.02.

4.08 *Quorum; Majority Vote.* At meetings of the executive committee, a majority of the number of members designated by the board of directors shall constitute a quorum for the transaction of business. The act of a majority of the members present at any meeting at which a quorum is present shall be the act of the executive committee, except as otherwise specifically provided by statute, the articles of incorporation, or these bylaws. If a quorum is not present at a meeting of the executive committee, the members present may adjourn the meeting from time to time, without notice other than an announcement at the meeting, until a quorum is present.¹¹⁷

4.09 *Compensation.* See Bylaw 3.12.¹¹⁸

4.10 *Procedure.* The executive committee shall keep regular minutes of its proceedings and report the same to the board of directors when required. The minutes of the proceedings of the executive committee shall be placed in the minute book of the corporation.¹¹⁹

112. On the last two powers listed in this bylaw see note 109(C) *supra*.

113. This provision is without express statutory authority but is consistent with the directors' express powers over the executive committee.

114. TBCA 2.43 (1956) so provides. Moreover, removal is without prejudice to the contract rights, if any, of the person so removed.

115. See note 113 *supra*.

116. This provision is without express statutory authority.

117. This provision is without express statutory authority but is consistent with Bylaw 3.11 on directors.

118. See note 104 *supra* and accompanying text.

119. This provision is without express statutory authority, but is consistent with TBCA 2.44(A) (Supp. 1975). For an example of the importance of executive committee minutes see *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 691, 695, 702 (S.D. N.Y. 1968). Liability was imposed on a lawyer-director, an underwriter, and an accounting firm, under Securities Act of 1933, § 11, 15 U.S.C.A. 77k (1971), for material misrepresentations and omissions in a company's registration statement. Some of the material information was contained in the minutes of the company's executive committee, or in notes of executive committee meetings which had not been written up as minutes. Each of these defendants failed to establish the "due diligence" defense in

4.11 *Action Without Meeting.* Any action required or permitted to be taken at a meeting of the executive committee may be taken without a meeting if a consent in writing, setting forth the action so taken, is signed by all the members of the executive committee. Such consent shall have the same force and effect as a unanimous vote at a meeting. The signed consent, or a signed copy, shall be placed in the minute book.¹²⁰

4.12 *Telephone and Similar Meetings.* See Bylaw 2.11.¹²¹

4.13 *Responsibility.* The designation of an executive committee and the delegation of authority to it shall not operate to relieve the board of directors, or any member thereof, of any responsibility imposed upon it or him by law.¹²²

Article 5: Notice

5.01 *Method.* Whenever by statute, the articles of incorporation, these bylaws, or otherwise, notice is required to be given to a director, committee member, or securityholder, and no provision is made as to how the notice shall be given, it shall not be construed to mean personal notice, but any such notice may be given: (a) in writing, by mail, postage prepaid, addressed to the director, committee member, or securityholder at the address appearing on the books of the corporation; or (b) in any other method permitted by law. Any notice required or permitted to be given by mail shall be deemed given at the time when the same is thus deposited in the United States mails.¹²³

5.02 *Waiver.* Whenever, by statute or the articles of incorporation or these bylaws, notice is required to be given to a securityholder, committee member, or director, a waiver thereof in writing signed by the person or persons entitled to such notice, whether before or after the time stated in such notice, shall be equivalent to the giving of such notice.¹²⁴ Attendance at a meeting shall constitute a waiver of notice of such meeting, except where a person attends for the express purpose of objecting to the transaction of any business on the ground that the meeting is not lawfully called or convened.¹²⁵

Article 6: Officers and Agents

6.01 *Number; Qualification; Election; Term.*

(a) The corporation shall have: (1) a president, a vice president, a secretary and a treasurer;¹²⁶ and (2) such other officers (including a chair-

§ 11, in part by failing to read the executive committee minutes or by failing to insist that the notes be transformed into minutes.

120. TBCA 9.10(B) (Supp. 1975) so provides.

121. See note 84 *supra* and accompanying text.

122. TBCA 2.36 (Supp. 1975) so provides.

123. This provision is without express statutory authority although it is consistent with provisions for notices of shareholder meetings. See TBCA 2.25 (1956). For notice provisions in other documents see text accompanying notes 352, 431 *infra*.

124. TBCA 9.09 (1956) so provides as to directors and shareholders. This bylaw extends to committee members.

125. TBCA 2.37 (1956) so provides as to directors. This bylaw extends to shareholders and committee members.

126. TBCA 2.42(A) (1956) requires these officers and specifies that they be elected by the directors; the time and manner of election is left to the bylaws. Bylaws for offi-

man of the board and additional vice presidents) and assistant officers and agents as the board of directors may think necessary.¹²⁷

(b) No officer or agent need be a shareholder, a director or a resident of Texas.¹²⁸

(c) Officers named in Bylaw 6.01(a)(1) shall be elected by the board of directors on the expiration of an officer's term or whenever a vacancy exists. Officers and agents named in Bylaw 6.01(a)(2) may be elected by the board at any meeting.

(d) Unless otherwise specified by the board at the time of election or appointment, or in an employment contract approved by the board, each officer's and agent's term shall end at the first meeting of directors after the next annual meeting of shareholders.¹²⁹ He shall serve until the end of his term or, if earlier, his death, resignation, or removal.

cers are presumably subject to any "close corporation" shareholders agreement. See note 85(C) *supra*.

127. TBCA 2.42(A) (1956) authorizes additional officers and agents in accordance with the bylaws.

128. Prior law provided that the president should be a director. Ch. 97, § 16, [1874] Tex. Laws 125, 8 H. GAMMEL, LAWS OF TEXAS 127 (1898) (repealed 1961). This will undoubtedly continue to be customary, since it is good business practice, and it may be specified in the bylaws if desired.

129. (A) TBCA fixes no term of office. Earlier cases were antagonistic to long terms, usually on the stated ground that they violated public policy, and the underlying premise that they tied the hands of future boards of directors. *Leon Farms Corp. v. Beeman*, 240 S.W.2d 433 (Tex. Civ. App.—El Paso 1951), *error ref. n.r.e.*, (and cases there cited at 437). See also *Mercury Life & Health Co. v. Hughes*, 271 S.W.2d 842 (Tex. Civ. App.—San Antonio 1954), *error ref.* (general manager's 10-year contract was unenforceable because of conflict of interest; public policy issue mentioned but not part of holding). A 1951 amendment to TEX. REV. CIV. STAT. ANN. art. 1327, ch. 97, § 21, [1874] Tex. Laws 125, 8 H. GAMMEL, LAWS OF TEXAS 127 (1898), stated that "Contracts of employment may be made . . . by the corporation with any of its officers, agents or employees for such period of time as the directors may approve and authorize, when not prohibited by the corporation's charter or by-laws . . ." Ch. 20, § 1, [1951] Tex. Laws 26 (repealed 1961).

(B) Some distrust of long-term contracts survived the 1951 amendment. See *Pioneer Specialties, Inc. v. Nelson*, 161 Tex. 244, 339 S.W.2d 199 (1960) (president's two-year employment contract unenforceable beyond one-year term specified for president in by-laws); *Nelms v. A & A Liquor Stores, Inc.*, 445 S.W.2d 256 (Tex. Civ. App.—Eastland 1969), *error ref. n.r.e.* (summary judgment for corporation in plaintiff's suit on alleged oral contract for lifetime employment (in unspecified capacity) affirmed; president lacked authority to make the contract); *Brown v. Grayson Enterprises, Inc.*, 401 S.W.2d 653 (Tex. Civ. App.—Dallas 1966), *error ref. n.r.e.* (summary judgment for corporation in plaintiff's suit on alleged oral contract for lifetime employment (in unspecified capacity, apparently as bookkeeper) affirmed; general manager and chairman-chief-executive-treasurer had no express or apparent authority to make such a contract).

(C) However, long-term agreements have been upheld in some situations. See *Miller v. A. & N.R.R.R.*, 476 S.W.2d 389 (Tex. Civ. App.—Beaumont 1972), *error ref. n.r.e.* (summary judgment for corporation in plaintiff's suit on written contract, signed by president, for 12-year employment as general manager reversed and remanded; bylaws provided for general manager to be appointed by president; company failed to show that president lacked authority to make 12-year contract with general manager, or that director approval was necessary); *Little v. Employees Sec. Life Ins. Co.*, 343 S.W.2d 517 (Tex. Civ. App.—Dallas 1961), *error ref. n.r.e.* (cause of action stated for breach of contract for more than one year; no bylaw mentioned; long-term contracts not against public policy since 1951); *Dixie Glass Co. v. Pollak*, 341 S.W.2d 530, 91 A.L.R.2d 662 (Tex. Civ. App.—Houston 1960), *error ref. n.r.e.* (bylaw restriction on terms waived when long-term employment contract was approved by directors and shareholders who had power to amend bylaws; employee entitled to recover for 5-year term and 3 additional 5-year optional terms). See generally HAMILTON §§ 590-91; Lebowitz, *Corporations, Annual Survey of Texas Law*, 27 Sw. L.J. 85, 94-96 (1973).

(D) The 1951 amendment to TEX. REV. CIV. STAT. ANN. art. 1327, Ch. 97, § 21, [1874] Tex. Laws 125, 8 H. GAMMEL, LAWS OF TEXAS 127 (1898), *as amended*, ch. 20, § 1, [1951] Tex. Laws 26 (repealed 1961), was repealed in the 1961 clean-up of

(e) Any two or more offices may be held by the same person, except that the president and the secretary shall not be the same person.¹³⁰

6.02 *Removal.* Any officer or agent elected or appointed by the board of directors may be removed by the board of directors whenever in its judgment the best interests of the corporation will be served thereby. Such removal shall be without prejudice to the contract rights, if any, of the person so removed. Election or appointment of an officer or agent shall not of itself create contract rights.¹³¹

6.03 *Vacancies.* Any vacancy occurring in any office of the corporation (by death, resignation, removal or otherwise) may be filled by the board of directors.

6.04 *Authority.* Officers and agents shall have such authority and perform such duties in the management of the corporation as are provided in these bylaws or as may be determined by resolution of the board of directors not inconsistent with these bylaws.¹³²

6.05 *Compensation.* The compensation of officers and agents shall be fixed from time to time by the board of directors.¹³³

6.06 *President.* The president shall be the chief executive officer of the corporation; he shall preside at all meetings of the shareholders and the board of directors, shall have general and active management of the business and affairs of the corporation, shall see that all orders and resolutions of the board

old statutes superceded by TBCA, TNPCA and TMCLA. Thus, authority for long-term contracts must be found in the new statutes. It is supplied by TBCA 2.02(A)(12) (Supp. 1975) which gives general power to every corporation to "elect or appoint officers and agents . . . for such period of time as the corporation may determine." TBCA 2.31 (1956) generally, and TBCA 2.42 (1956) specifically, put the power over officers in the hands of the directors. See the cases cited in the previous paragraph. Long-term contract authority is also given for "close corporations" by TBCA 2.30-2(A)(4) (Supp. 1975) which permits shareholders to agree unanimously on "terms and conditions of employment of any shareholder, director, officer, or employee regardless of the length of time of such employment." See note 85(C) *supra*.

(E) In view of the suspicion accorded long-term contracts, it pays the draftsman to be specific about terms in the bylaws. In deciding what sort of provision is appropriate, he must weigh the alternatives of: (1) security of employment and position for officers (which may be important in attracting executive talent), and (2) facility of management change for the corporation. The bylaw as written inclines toward the former; however, it must be read with TBCA 2.43 (1956) and Bylaw 6.02 which permit removal at any time, without prejudice to contract rights (*i.e.*, permitting damages for removal in breach of contract).

(F) Other terms might be specified in the bylaws in appropriate instances: (1) one year; (2) until the first meeting of directors after the next annual meeting of shareholders (the same result is reached by the common provision that officers shall be elected at the first meeting of directors after each annual meeting of shareholders); or (3) at the pleasure of the board.

130. TBCA 2.42(A) (1956) so provides.

131. This section is a paraphrase of TBCA 2.43 (1956).

132. TBCA 2.42(B) (1956) so provides, but is expressly limited to relations with the corporation and does not purport to bind third persons. See also TBCA 2.02(B) (1956); HAMILTON §§ 582, 586.

133. TBCA 2.02(A)(12) (Supp. 1975) gives "the corporation" power to fix compensation. This power normally falls to the directors under their general management authority. TBCA 2.31 (1956). However, compensation may be specified in the bylaws, although this method is relatively inflexible and may cause problems. See *Turners, Inc. v. Klaus*, 341 S.W.2d 182 (Tex. Civ. App.—San Antonio 1960), *error ref. n.r.e.* (manager entitled to recover salary prescribed in bylaws; it was not a debt improperly incurred without approval of directors). See also note 109 *supra* (on the possibility of a Compensation Committee of outside directors).

are carried into effect. He shall perform such other duties and have such other authority and powers as the board of directors may from time to time prescribe.¹³⁴

6.07 Vice President. The vice presidents in the order of their seniority, unless otherwise determined by the board of directors, shall, in the absence or disability of the president, perform the duties and have the authority and exercise the powers of the president. They shall perform such other duties and have such other authority and powers as the board of directors may from time to time prescribe or as the president may from time to time delegate.

6.08 Secretary.

(a) The secretary shall attend all meetings of the board of directors and all meetings of the shareholders and record all votes, actions and the minutes of all proceedings in a book to be kept for that purpose and shall perform like duties for the executive and other committees when required.

(b) He shall give, or cause to be given, notice of all meetings of the shareholders and special meetings of the board of directors.

(c) He shall keep in safe custody the seal of the corporation and, when authorized by the board of directors or the executive committee, affix it to any instrument requiring it. When so affixed, it shall be attested by his signature or by the signature of the treasurer or an assistant secretary.

(d) He shall be under the supervision of the president. He shall perform such other duties and have such other authority and powers as the board of directors may from time to time prescribe or as the president may from time to time delegate.¹³⁵

6.09 Assistant Secretary. The assistant secretaries in the order of their seniority, unless otherwise determined by the board of directors, shall, in the absence or disability of the secretary, perform the duties and have the authority and exercise the powers of the secretary. They shall perform such other duties and have such other powers as the board of directors may from time to time prescribe or as the president may from time to time delegate.

6.10 Treasurer.

(a) The treasurer shall have the custody of the corporate funds and

134. (A) A provision substantially identical to this did not impose on the president the exclusive duty to sell a corporate asset when the directors authorized and directed "the officers" to make the sale; hence, he was not personally liable for failing to make the sale. *Henger v. Sale*, 357 S.W.2d 774 (Tex. Civ. App.—Waco 1962), *aff'd on this point*, 365 S.W.2d 335 (Tex. 1963).

(B) The president has authority to hire and fire employees. *Mr. Eddie, Inc. v. Ginsberg*, 430 S.W.2d 5, 10 (Tex. Civ. App.—Eastland 1968), *error ref. n.r.e.* Sometimes the bylaws expressly provide for this authority. But he may not have authority, without a fairly specific bylaw or resolution, to make long-term contracts with employees. See note 129(B) *supra*. See generally HAMILTON §§ 585-86; Lebowitz, *Corporations, Annual Survey of Texas Law*, 26 Sw. L.J. 86, 160-63 (1972).

(C) If there is to be a shareholders agreement (see note 85(C) *supra*), Bylaw 6.08 (a) might specify that the secretary keep that agreement with the minutes, bylaws, and articles of incorporation.

135. (A) Cf. Choka, *Six Check Lists for the Corporate Secretary*, 5 PRAC. LAW., Jan. 1959, at 85, reprinted in 1 CORP. PRAC. COM., Feb. 1960, at 39.

(B) The secretary's duties, such as signing stock certificates, are considered ministerial. *Holland v. American Founders Life Ins. Co.*, 151 Colo. 69, 376 P.2d 162 (1962) (secretary not liable for issuance of stock in exchange for other stock which resulted in loss; no breach of fiduciary duty by him).

securities and shall keep full and accurate accounts of receipts and disbursements of the corporation and shall deposit all moneys and other valuables in the name and to the credit of the corporation in depositories designated by the board of directors.

(b) He shall disburse the funds of the corporation as ordered by the board of directors, and prepare financial statements as they direct.

(c) If required by the board of directors, he shall give the corporation a bond (in such form, in such sum, and with such surety or sureties as shall be satisfactory to the board) for the faithful performance of the duties of his office and for the restoration to the corporation, in case of his death, resignation, retirement or removal from office, of all books, papers, vouchers, money and other property of whatever kind in his possession or under his control belonging to the corporation.

(d) He shall perform such other duties and have such other authority and powers as the board of directors may from time to time prescribe or as the president may from time to time delegate.

6.11 Assistant Treasurer. The assistant treasurers in the order of their seniority, unless otherwise determined by the board of directors, shall, in the absence or disability of the treasurer, perform the duties and have the authority and exercise the powers of the treasurer. They shall perform such other duties and have such other powers as the board of directors may from time to time prescribe or the president may from time to time delegate.

Article 7: Certificates and Shareholders

7.01 Certificates. Certificates in the form determined by the board of directors shall be delivered representing all shares to which shareholders are entitled. Certificates shall be consecutively numbered and shall be entered in the books of the corporation as they are issued. Each certificate shall state on its face the holder's name, the number and class of shares, the par value of shares or a statement that such shares are without par value, and such other matters as may be required by law. It shall be signed by the president or a vice president and such other officer or officers as the board of directors shall designate, and may be sealed with the seal of the corporation or a facsimile thereof. If a certificate is countersigned by a transfer agent, or an assistant transfer agent or registered by a registrar (either of which is other than the corporation or an employee of the corporation), the signature of any officer may be facsimile.¹³⁶

136. (A) Most of this section is a paraphrase of TBCA 2.19(A), (C) (Supp. 1975). The remainder of TBCA 2.19 (Supp. 1975) contains other specifications regarding the form and content of certificates. For implementation see text accompanying note 187 *infra*. For issuance of shares see text accompanying notes 188-208 *infra*. For the form of stock certificates see notes 247-68 *infra* and accompanying text. Fractional shares and scrip are authorized by TBCA 2.20 (Supp. 1975).

(B) All of article 7 of the Bylaws is written in terms of "shares." Most of it could usefully be extended to other securities, such as warrants and perhaps debentures, which the corporation might issue. The extension could be made by changing "shares" to "securities" in Bylaws 7.04-7.09. Bylaws 7.01-7.03 contain some provisions which are uniquely applicable to shares, and would therefore require some parallel but modified provisions for other kinds of securities. If article 7 is extended to other securities, cer-

7.02 *Issuance.* Shares (both treasury and authorized but unissued) may be issued for such consideration (not less than par value) and to such persons as the board of directors may determine from time to time.¹³⁷ Shares may not be issued until the full amount of the consideration, fixed as provided by law, has been paid.¹³⁸

7.03 *Payment for Shares.*

(a) *Kind.* The consideration for the issuance of shares shall consist of money paid, labor done, (including services actually performed for the corporation) or property (tangible or intangible) actually received.¹³⁹ Neither promissory notes nor the promise of future services shall constitute payment for shares.¹⁴⁰

(b) *Valuation.* In the absence of fraud in the transaction, the judgment of the board of directors as to the value of consideration received shall be conclusive.¹⁴¹

(c) *Effect.* When consideration, fixed as provided by law, has been paid, the shares shall be deemed to have been issued and shall be considered fully paid and nonassessable.¹⁴²

(d) *Allocation of Consideration.* The consideration received for shares shall be allocated by the board of directors, in accordance with law, between stated capital and capital surplus accounts.¹⁴³

tificates for the other securities should include references to the bylaws like those accompanying notes 256-57 *infra*.

(C) For examples of certificates for warrants and convertible debentures see text accompanying notes 328-435 *infra*.

137. TBCA 2.15(A)-(C) (1956) provide generally that the directors may fix the consideration for shares. The bylaw restates this power and adds that the directors may determine the persons to whom the shares will be issued. The latter power probably belongs to the directors under their general authority to manage the business. See Bylaw 3.01; TBCA 2.31 (1956). It is spelled out here to avoid any possible doubt.

By appropriate provisions the power to issue shares can be given to an executive committee instead of the board of directors. See notes 109(C), 112 *supra* and accompanying text.

This bylaw is not intended to override equitable limitations or fiduciary duties of the directors in issuing shares to themselves or for their benefit. Nor is the bylaw intended to override valid subscriptions or agreements for share purchase. If pre-emptive rights are preserved, this bylaw should be made subject to the modified ¶ 9 of the Articles of Incorporation and Bylaw 7.09 which specify the pre-emptive rights, since in some instances the pre-emptive rights will determine the person to whom the shares may be issued. This bylaw is stricter than TBCA 2.15(C) (1956) in that the statute permits treasury shares to be sold at any consideration fixed by the board (*i.e.*, even though less than par value) while the bylaw requires treasury shares, like all other shares, to be sold at par or above. There is something to be said for uniformity in this respect, especially since par value is typically kept low enough that it is not an obstacle. See note 9 *supra*. If there is reason to want authority to sell treasury shares below par, the bylaw should be modified.

138. TBCA 2.16(A) (Supp. 1975) so provides.

139. This is an amplification of TBCA 2.16(A) (Supp. 1975) and of TEX. CONST. art. XII, § 6 ("no corporation shall issue stock . . . except for money paid, labor done or property actually received. . . ."). For implementation see notes 196, 198-200 *infra* and accompanying text. For corresponding problems of consideration for warrants and debt securities see notes 328(C), 358(C) *infra*.

140. TBCA 2.16(B) (1956) so provides.

141. TBCA 2.16(C) (1956) so provides. For implementation see note 197 *infra* and accompanying text.

142. TBCA 2.16(A) (Supp. 1975) so provides.

143. TBCA 2.17(A)-(B) (1956) set the limits on the directors' allocation of consideration between stated capital and capital surplus. For implementation see text accompanying notes 201, 206-07 *infra*.

7.04 *Subscriptions.* Unless otherwise provided in the subscription agreement, subscriptions for shares, whether made before or after organization of the corporation, shall be paid in full at such time or in such installments and at such times as shall be determined by the board of directors. Any call made by the board of directors for payment on subscriptions shall be uniform as to all shares of the same series. In case of default in the payment on any installment or call when payment is due, the corporation may proceed to collect the amount due in the same manner as any debt due to the corporation.¹⁴⁴

7.05 *Lien.* For any indebtedness of a shareholder to the corporation, the corporation shall have a first and prior lien on all shares of its stock owned by him and on all dividends or other distributions declared thereon.¹⁴⁵

7.06 *Lost, Stolen or Destroyed Certificates.* The corporation shall issue a new certificate in place of any certificate for shares previously issued if the registered owner of the certificate:

(a) *Claim.* Makes proof in affidavit form that it has been lost, destroyed or wrongfully taken; and

(b) *Timely Request.* Requests the issuance of a new certificate before the corporation has notice that the certificate has been acquired by a purchaser for value in good faith and without notice of an adverse claim; and

(c) *Bond.* Gives a bond in such form, and with such surety or sureties, with fixed or open penalty, as the corporation may direct, to indemnify the corporation (and its transfer agent and registrar, if any) against any claim that may be made on account of the alleged loss, destruction, or theft of the certificate; and

(d) *Other Requirements.* Satisfies any other reasonable requirements imposed by the corporation.

When a certificate has been lost, apparently destroyed or wrongfully taken, and the holder of record fails to notify the corporation within a reasonable time after he has notice of it, and the corporation registers a transfer of the shares represented by the certificate before receiving such notification, the holder of record is precluded from making any claim against the corporation for the transfer or for a new certificate.¹⁴⁶

7.07 *Registration of Transfer.* The corporation shall register the transfer of a certificate for shares presented to it for transfer if:

(a) *Endorsement.* The certificate is properly endorsed by the registered owner or by his duly authorized attorney; and

(b) *Guarantee and Effectiveness of Signature.* The signature of such person has been guaranteed by a national banking association or member of

144. TBCA 2.14(D) (1956) so provides. The subscription procedure is not widely used. See note 60 *supra*.

145. There is no absolute statutory authority for a lien in favor of the corporation on its shares. Such a lien is valid against a purchaser only if the corporation's right is conspicuously noted on the certificate. TEX. BUS. & COMM. CODE ANN. § 8.103 (1968). See also *id.* § 8.204 (unless noted conspicuously on the certificate an issuer-imposed transfer restriction is ineffective except against persons with actual knowledge); note 264 *infra*; HAMILTON § 782 (and Supp. 1974).

146. This section is based on TEX. BUS. & COMM. CODE ANN. § 8.405 (1968). See HAMILTON § 785.

the New York Stock Exchange, and reasonable assurance is given that such endorsements are effective; and

(c) *Adverse Claims*. The corporation has no notice of an adverse claim or has discharged any duty to inquire into such a claim; and

(d) *Collection of Taxes*. Any applicable law relating to the collection of taxes has been complied with.^{147 148}

7.08 *Registered Owner*. Prior to due presentment for registration of transfer of a certificate for shares, the corporation may treat the registered owner as the person exclusively entitled to vote, to receive notices and otherwise to exercise all the rights and powers of a shareholder.¹⁴⁹

7.09 *Pre-Emptive Rights*. No shareholder or other person shall have any pre-emptive right whatsoever.¹⁵⁰

Article 8: General Provisions

8.01 *Dividends and Reserves*.

(a) *Declaration and Payment*. Subject to statute and the articles of incorporation, dividends may be declared by the board of directors at any regular or special meeting and may be paid in cash, in property, or in shares of the corporation.¹⁵¹ The declaration and payment shall be at the discretion of the board of directors.¹⁵²

(b) *Record Date*. The board of directors may fix in advance a record date for the purpose of determining shareholders entitled to receive payment of any dividend, the record date to be not more than fifty days prior to the payment date of such dividend, or the board of directors may close the stock

147. This section is a summary of TEX. BUS. & COMM. CODE ANN. §§ 8.401, 8.308 and 8.403 (1968). These statutory provisions apply equally to other investment securities issued by the company, such as the warrant and convertible debenture illustrated in the text. On the possibility of extending the bylaws to securities other than shares see note 136(B) *supra*.

For a more detailed bylaw provision, incorporating more of the Code, and designed to give greater guidance to a company acting as its own transfer agent see K. PANTZER & R. DEER, *THE DRAFTING OF CORPORATE CHARTERS AND BYLAWS* 228-32 (2d ed. 1968).

A closely held company will often waive signature guarantee if the transferring shareholder is well known to it.

On transfer of securities generally see F. CHRISTY, *TRANSFER OF STOCK—LAW AND PRACTICE* (5th ed. 1975); HAMILTON §§ 771-783; C. ISRAELS & E. GUTTMAN, *MODERN SECURITIES TRANSFERS* (rev. ed. 1971 & Supp. 1974).

148. Reasonable restrictions may be imposed on the transfer of shares by the articles of incorporation or bylaws. TBCA 2.22 (Supp. 1975). Even broader restrictions apparently can be imposed by a "close corporation" shareholder agreement. See note 85 (C) *supra*. See also note 264 *infra*. See generally HAMILTON §§ 673-84.

149. TEX. BUS. & COMM. CODE ANN. § 8.207(1) (1968) so provides.

150. See note 14 *supra* and accompanying text. Pre-emptive rights are presumably subject to "close corporation" shareholder agreements. See note 85(C) *supra*.

151. TBCA 2.38(A) (1956) generally so provides but it and TBCA 2.39 (1956) and TBCA 2.40 (1956) contain a number of details which are omitted from these bylaws. See generally HAMILTON §§ 611-29. If the executive committee is given authority to declare dividends (see Bylaw 4.03(i) and note 109(C) *supra*), Bylaw 8.01 should be conformed. The declaration of dividends may be controlled by a "close corporation" shareholders agreement. See note 85(C) *supra*. For examples of dividend restrictions see text accompanying notes 282, 312 *infra*. On contractual restrictions see note 388 *infra*.

152. This is consonant with the permissive language of TBCA 2.38(A) (1956) and the "expedient" language of TBCA 2.38(C) (1956) which is carried over from what was formerly TEX. REV. CIV. STAT. ANN. art. 1329, ch. 47, § 21, [1874] Tex. Laws 125, 8 H. GAMMEL, *LAWS OF TEXAS* 127 (repealed 1961).

transfer books for such purpose for a period of not more than fifty days prior to the payment date of such dividend. In the absence of any action by the board of directors, the date upon which the board of directors adopts the resolution declaring the dividend shall be the record date.¹⁵³

(c) *Reserves.* By resolution the board of directors may create such reserve or reserves out of the earned surplus of the corporation as the directors from time to time, in their discretion, think proper to provide for contingencies, or to equalize dividends, or to repair or maintain any property of the corporation, or for any other purpose they think beneficial to the corporation. The directors may modify or abolish any such reserve in the manner in which it was created.¹⁵⁴

8.02 *Books and Records.* The corporation shall keep correct and complete books and records of account and shall keep minutes of the proceedings of its shareholders and board of directors, and shall keep at its registered office or principal place of business, or at the office of its transfer agent or registrar, a record of its shareholders, giving the names and addresses of all shareholders and the number and class of the shares held by each.¹⁵⁵

8.03 *Annual Statement.* The board of directors shall mail to each shareholder of record, at least 10 days before each annual meeting, a full and clear statement of the business and condition of the corporation, including a reasonably detailed balance sheet, income statement, surplus statement, and statement of changes in financial position, for the last fiscal year and for the prior fiscal year, all prepared in conformity with generally accepted accounting principles applied on a consistent basis [and certified by independent public accountants].¹⁵⁶

8.04 *Checks and Notes.* All checks or demands for money and notes of the corporation shall be signed by such officer or officers or such other person or persons as the board of directors may from time to time designate.¹⁵⁷

8.05 *Fiscal Year.* The fiscal year of the corporation shall be fixed by resolution of the board of directors.¹⁵⁸

153. TBCA 2.26 (1956) so provides.

154. TBCA 4.13(C) (1956) so provides.

155. TBCA 2.44 (Supp. 1975) so provides.

156. There is no express statutory requirement for this provision. It goes considerably beyond Bylaw 8.02 and TBCA 2.44 (Supp. 1975) and TBCA 2.38(C) (1956) which provide rather generally for the keeping of financial records and their accessibility to shareholders. A shareholder may examine comparable data filed with the secretary of state as part of the franchise tax return. TEX. TAX-GEN. ANN. art. 12.10 (1969). Alternatively, if he owns as much as 1%, the shareholder can see the federal income tax returns of the corporation and its subsidiaries. INT. REV. CODE OF 1954, § 6103(c) [hereinafter cited as I.R.C.]. If the corporation is listed on a national securities exchange, or if it has as many as 500 shareholders of record and \$1,000,000 of assets, detailed financial statements must be sent to shareholders pursuant to SEC Exchange Act Rules 14a-3(b), 14c-3(a), 17 C.F.R. §§ 240.14a-3(b), 240.14c-3(a) (1974). It is ironic that state corporate law is so backward in affording shareholders basic information on their investment. This bylaw compensates in some measure for this deficiency. If the bracketed requirement of certification by independent accountants is included, investor protection is enhanced, but costs are incurred which may be disproportionate to benefits for the closely held or small company. Quarterly income reports are issued by most publicly held companies and can be required if desired. For an example of the financial statements typically required by creditors see text accompanying note 391 *infra*.

157. For implementation see text accompanying note 211 *infra*.

158. For implementation see text accompanying note 219 *infra*.

8.06 *Seal*. The corporation seal (of which there may be one or more exemplars) shall contain the name of the corporation and the name of the state of incorporation. The seal may be used by impressing it or reproducing a facsimile of it, or otherwise.¹⁵⁹

8.07 *Indemnification*. [Same as ¶ 17 of Articles of Incorporation, *supra*.¹⁶⁰]

8.08 *Resignation*. Any director, committee member, officer or agent may resign by giving written notice to the president or the secretary. The resignation shall take effect at the time specified therein, or immediately if no time is specified. Unless otherwise specified therein, the acceptance of such resignation shall not be necessary to make it effective.

8.09 *Amendment of Bylaws*.

(a) These bylaws may be altered, amended, or repealed at any meeting of the board of directors at which a quorum is present, by the affirmative vote of a majority of the directors present at such meeting, provided notice of the proposed alteration, amendment, or repeal is contained in the notice of the meeting.¹⁶¹

(b) These bylaws may also be altered, amended or repealed at any meeting of the shareholders at which a quorum is present or represented, by the affirmative vote of the holders of a majority of the shares present or represented at the meeting and entitled to vote thereat, provided notice of the proposed alteration, amendment or repeal is contained in the notice of the meeting.

8.10 *Construction*. Whenever the context so requires, the masculine shall include the feminine and neuter, and the singular shall include the plural, and conversely. If any portion of these bylaws shall be invalid or inoperative, then, so far as is reasonable and possible:

(a) The remainder of these bylaws shall be considered valid and operative, and

(b) Effect shall be given to the intent manifested by the portion held invalid or inoperative.

8.11 *Table of Contents; Headings*. The table of contents and headings are

159. A seal is optional. TBCA 2.02(A)(3) (Supp. 1975); TBCA 5.08 (1956). For its use see Bylaws 6.08, 4.02. For implementation, and further details see note 186 *infra*, and accompanying text.

160. See note 24 *supra*, and accompanying text.

161. (A) See note 15 *supra*, and accompanying text. If only the shareholders are to have amendment powers, Bylaw 8.09(a) should be deleted.

(B) Despite the formal procedure established for amendment, there remains the possibility that some informal action will be held to modify the bylaws. See *Dixie Glass Co. v. Pollak*, 341 S.W.2d 530, 91 A.L.R.2d 662 (Tex. Civ. App.—Houston 1960), *error ref. n.r.e.* (waiver); *Keating v. K-C-K Corp.*, 383 S.W.2d 69 (Tex. Civ. App.—Houston 1964) (implied amendment ?); TBCA 2.30-1(B)(3) (Supp. 1975) (consent of all shareholders, variously manifested, if “close corporation”). On the other hand, even formal compliance with the prescribed procedure will not accomplish certain things, such as restricting transfer of outstanding shares without the owner’s consent. *Sandor Petroleum Corp. v. Williams*, 321 S.W.2d 614 (Tex. Civ. App.—Eastland 1959), *error ref. n.r.e.*

(C) Amendment of the bylaws is presumably subject to any “close corporation” shareholders agreement. See note 85(C) *supra*.

(D) For amendment of convertible notes by the holders see text accompanying notes 398-400 *infra*.

for organization, convenience and clarity. In interpreting these bylaws, they shall be subordinated in importance to the other written material.

8.12 *Relation to Articles of Incorporation.* These Bylaws are subject to, and governed by, the Articles of Incorporation.¹⁶²

III. MINUTE BOOK OF THE ABC CORP.¹⁶³

A. Authentication¹⁶⁴

ABC CORP. was organized under the laws of the State of Texas on _____, 19__.

162. This is a reminder that there are provisions in the articles of incorporation which are not restated in the bylaws (*e.g.*, purpose, duration, authorized shares) and that the articles control in the event of inconsistency between them and the bylaws. See note 61(C), (E) *supra*.

163. (A) These minutes are drafted to comply with Texas law. The form will not vary greatly in other jurisdictions. Minutes are required by TBCA 2.44(A) (Supp. 1975) and customarily by the bylaws. See Bylaws 3.13, 4.10, 6.08(a), 8.02. They are legal documents and should be prepared by lawyers. No particular form is prescribed, but some phrases are suggested by statutes and decisions; clarity and completeness are always desirable in permanent records. Although verbatim transcripts or bare outlines may be used, the present form is most common: slight narrative of actions and full quotation of resolutions. Whether to include greater detail (*e.g.*, concerning discussion of resolutions or matters not acted on) is largely within the draftsman's discretion. In considering the problem he should bear in mind that the minutes are: (a) subject to inspection by stockholders pursuant to TBCA 2.44(B) (Supp. 1975), and (b) evidence of corporate acts which may be helpful or harmful to the corporation in a dispute. On the evidence questions see 9 W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 4633 (perm. ed. 1964); 5 J. WIGMORE, *EVIDENCE* § 1661 (3d ed. 1940); 9 *id.* § 2451. On the general character, style, and content of corporate minutes see 1 L. DORIS & E. FRIEDMAN, *ENCYCLOPEDIA OF CORPORATE MEETINGS, MINUTES AND RESOLUTIONS* 171-87 (1958); 19 W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* §§ 8947-55 (1959). On their importance for tax purposes see Brockman, *Watch Those Corporate Minutes*, 46 *TAXES* 612 (1968); Eberle, *Advice to Close Corporations: Spend a Few Hours on Your Minutes*, 1 *TAXATION FOR ACCOUNTANTS* 180 (No. 3, July-Aug. 1966), reprinted in *DRAFTING OPINIONS AND CORPORATE INSTRUMENTS* 227 (1971); Goldworn, *Using Corporate Minutes in Tax Planning*, P-H *TAX IDEAS* ¶ 15,002 (1971); Holzman, *Watch Your Minutes*, 43 *HARV. BUS. REV.* 162 (No. 3, Mar.-Apr. 1965), reprinted in *DRAFTING OPINIONS AND CORPORATE INSTRUMENTS* 219 (1971); Tarleau, *The Role of Corporate Minutes in Taxation*, U. SO. CAL. 1957 *TAX INST.* 1. Bylaws or resolutions may prescribe where the minutes shall be kept; it is common to have multiple copies (*e.g.* one at the corporation's office and another at the attorney's); cf. Bylaw 6.08.

Numerous forms of Minutes are in L. DORIS & E. FRIEDMAN, *ENCYCLOPEDIA OF CORPORATE MEETINGS, MINUTES AND RESOLUTIONS* (1958); 2 W. FLETCHER, *CORPORATE FORMS ANNOTATED* (1973); G. SEWARD, *BASIC CORPORATE PRACTICE* 202-16 (1966, Supp. 1969); 1 P-H *CORP.* ¶¶ 937-43, 1015-25, 1612 (1973). See also Wolf, *Organizing a Close Corporation in Texas*, 27 *TEX. B.J.* 325 (1964).

(B) For an example of how confused things may become when minutes are written but not implemented see *Star Corp. v. General Screw Prod. Co.*, 501 S.W.2d 374 (Tex. Civ. App.—Houston [1st Dist.] 1973), *error ref. n.r.e.* The dispute in this case concerned whether \$150,000 was paid by the parent corporation to its subsidiary solely as consideration for a stock purchase or partly as an advance to be repaid at some future date. Organizational minutes which treated the entire amount as consideration for the stock were written but not read at the organizational meeting. The court rejected evidence of a non-minute, informal agreement between two of three original directors that the funds were to be repaid, but remanded the case for determination whether there was a similar pre-incorporation agreement by these same individuals in their capacity as promoters of the subsidiary. If such an agreement was entered, the court indicated it would be binding.

164. Authentication is not required, but helps to identify the contents and to increase their evidentiary value. Since the minute book is customarily looseleaf, an authentication on the first page has only moderate probative force. The evidentiary value of looseleaf minutes can be increased by numbering the pages consecutively (to show complete-

This is the Minute Book of ABC CORP. adopted by resolution of the directors of the Corporation at their first meeting on _____, 19____. In order to identify and authenticate this Minute Book, all of the directors sign on this date.

s/	Arthur A. Adams
	_____ Arthur A. Adams
s/	Bernard B. Brooks
	_____ Bernard B. Brooks
s/	Charles C. Carnes
	_____ Charles C. Carnes

**B. Minutes of the Organizational Meeting
of Directors of ABC Corp.**

_____, 19____

Contents

1. Convening of Meeting
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1. Convening of Meeting.¹⁶⁵ The organizational meeting¹⁶⁶ of the Directors

ness), by having each page signed (*e.g.*, by the secretary) or by having them permanently bound at intervals. *See* note 222 *infra*.

165. Paragraph numbers and captions are ordinarily not used but they greatly facilitate access and reference. They also facilitate subject indexing, which becomes more valuable as the company grows older and accumulates more minutes which need to be referred to from time to time.

166. (A) An organizational meeting is required. TBCA 3.06 (Supp. 1975). Like other board meetings, this one may be held by telephone. TBCA 9.10(c) (Supp. 1975); Bylaws 3.15, 2.11. Or this meeting may be supplanted by a unanimous consent

of ABC Corp. was convened in the offices of the Corporation at 1000 Texas St., Dallas, Texas, at 11:00 a.m. on _____, 19____, pursuant to call by a majority of the directors named in the Articles of Incorporation, as evidenced by their signatures.¹⁶⁷ Each person named as an initial director in the Articles of Incorporation was present, accepted his office, and began the discharge of its duties:¹⁶⁸

Arthur A. Adams

Bernard B. Brooks

Charles C. Carnes

Each Director waived notice of the time, place and purpose of the meeting as evidenced by his signature.¹⁶⁹ By unanimous consent, Arthur A. Adams served as Chairman of the meeting and Charles C. Carnes served as Secretary of the meeting.¹⁷⁰

2. *Acceptance of Articles of Incorporation.* Mr. Carnes advised that the Articles of Incorporation of the Corporation had been filed in the Office of the Secretary of State of the State of Texas on _____, 19____, and a Certificate of Incorporation issued on the same day.¹⁷¹ The Articles were reviewed by the Directors. On motion duly made, seconded¹⁷² and unani-

without a meeting. TBCA 9.10(B) (Supp. 1975); Bylaw 3.14. The minutes should reflect the format actually used.

(B) *Shareholder Management.* Even if the articles provide for shareholder management of the company (see note 21 *supra* and accompanying text; note 85(B) *supra*), there must be an organizational meeting of the directors named in the articles. For there are no shareholders until shares are issued, and the directors are necessary to do this. Thus, the meeting should be a joint meeting of directors and shareholders, with the directors acting in §§ 1-3, 5-8 (and perhaps 9-10), and the shareholders acting on the other matters. The minutes should reflect who is acting, and under what authority.

(C) *Shareholders Agreement.* If there is a "close corporation" shareholders agreement (note 85(C) *supra*) covering matters such as the issuance of shares, and designation of officers and compensation, the minutes should probably state that consideration was paid and shares were executed and delivered and accepted pursuant to the shareholder agreement dated _____, 19____ on file with the corporation, and that named persons were designated as officers at specified compensation for specified terms, pursuant to the same agreement, and accepted their offices and began the discharge of their duties. Prior to this, it is probably wise to record an acceptance of the shareholders agreement like the acceptance of the articles of incorporation in § 2 of the Minutes.

167. This may be an excessive precaution. It is suggested because TBCA 3.06 (Supp. 1975) requires notice and call. No part of the TBCA expressly permits waiver of the call in the manner that TBCA 9.09 (1956) permits waiver of the notice.

168. Initial directors are designated by Articles of Incorporation § 7 pursuant to TBCA 3.02(A)(12) (Supp. 1975). A quorum is determined by TBCA 2.35 (Supp. 1975) and, after its adoption, by Bylaw 3.11. In case of doubt, it may be desirable to recite in the minutes that a quorum is present. In all events, each person who is present should be named. There is no requirement that the incorporators be present. A recitation that the directors accepted and began their duties precludes technical arguments over when or whether they became directors.

169. TBCA 3.06 (Supp. 1975) requires notice of the meeting to be given by the incorporators. This is seldom done, since the recitations in the minutes and the signatures thereto effect a waiver pursuant to TBCA 9.09 (1956) and Bylaw 5.02.

170. There is no requirement for temporary officers but good parliamentary procedure suggests that they be used.

171. The purpose of this recitation is simply identification.

172. Parliamentary procedure is usually employed although not prescribed by statutes or bylaws. It is generally not considered essential to name the persons who make and second the various motions, but it may be desirable to include this information to fortify the record against possible challenges. H. ROBERT, *ROBERT'S RULES OF ORDER* (S. Robert rev. 1971), or other procedural manuals, may be adopted by resolution or bylaws.

mously¹⁷³ adopted, the Articles of Incorporation were accepted and approved.¹⁷⁴

3. *Bylaws.* Mr. Carnes presented a form of Bylaws for the regulation and management of the affairs of the Corporation. They were reviewed by the Directors. On motion duly made, seconded and unanimously adopted, it was:

RESOLVED that the Bylaws submitted to and reviewed by this meeting are adopted as the Bylaws of this Corporation¹⁷⁵ and the Secretary shall insert them in the Minute Book.^{176 177}

4. *Officers.* On nomination and by unanimous¹⁷⁸ vote, the following were elected officers¹⁷⁹ with the titles and salaries shown (the salaries to be paid for each month on the last day of that month) to serve until the first Directors' meeting after the next annual shareholders' meeting.¹⁸⁰

173. Generally, votes need not be unanimous; a majority of those present is sufficient unless a greater number is required by the articles of incorporation or the bylaws. TBCA 2.35 (Supp. 1975); Bylaw 3.11. It is sensible to list as dissents any negative votes, specifying the persons who cast them. This affords the dissenters the specific protection of TBCA 2.41(B) (1956) against the liabilities of TBCA 2.41(A) (1956) and some common law protection against other charges of wrongdoing. If any director fails to vote (*e.g.*, because of conflict of interest), this fact should be recorded. Some draftsmen like the air of democratic deliberation obtained by inserting "fully discussed" after "seconded."

174. This is probably an empty ritual, but it may have some efficacy if a question is later raised about the binding effect of any of the articles.

175. Adoption of bylaws at the organizational meeting of directors is mandatory. TBCA 3.06 (1956). The order of business at the meeting is not fixed by law, but logically the bylaws should be adopted at this point since they govern most of the matters that follow. TBCA 2.42 (1956) recognizes this with respect to officers.

176. Inclusion of the bylaws in the minute book is recommended for convenience and completeness. *See also* note 184 *infra* and accompanying text.

177. Resolutions should be self-contained since they often have to be extracted and certified as evidence of corporate action. They may be consecutively numbered (*e.g.*, 1975-1, 1975-2, etc.) for easier reference.

178. Texas has no statutory guidance on the propriety of participation by "interested" directors in the establishment of their own compensation, issuance of shares to themselves, etc. Some courts have found such actions "void" or "voidable" or "unenforceable." *See* *Mercury Life & Health Co. v. Hughes*, 271 S.W.2d 842 (Tex. Civ. App.—San Antonio 1954), *error ref.*; H. BALLANTINE, *CORPORATIONS* 167 (1946). The situation is probably not cured by having each director withdraw when his transaction is consummated, then return to reciprocate for his fellows. *See* *Stoiber v. Miller Brewing Co.*, 257 Wis. 13, 42 N.W.2d 144 (1950). There is even some doubt whether an "interested" director can be counted for a quorum. The practical solution in small corporations is to rely on stockholder ratification which should be explicit and prompt. Even if all the stockholders happen to be directors and have approved the transaction in the latter capacity, no harm will result from confirming it in the former. It may also be desirable to have a provision in the bylaws or the articles of incorporation expressly validating all actions of "interested" directors in the absence of bad faith or fraud or some other appropriate standard. *See* Bylaw 3.16 and Articles of Incorporation ¶ 16 *supra*. *Cf.* TBCA 2.41(D) (1956) (director not liable for good faith act in reliance on opinion of company attorney).

179. Election of officers at the organizational meeting is mandatory. TBCA 3.06 (Supp. 1975). TBCA 2.42 (1956) and 2.43 (1956) and Bylaws 6.01-6.11 should be consulted for their bearing on the manner of elections, terms, duties, etc.

180. Frequently this language constitutes the entire employment agreement between the officer and the corporation. If a longer term is desired, it should be specified although it may not exceed the maximum permitted by the bylaws. *See* Bylaw 6.01 and note 129 *supra*. Occasionally officers are elected "to serve at the pleasure of the Board of Directors." If a more elaborate arrangement is contemplated, it should be reduced to writing and specifically approved by the directors. Bear in mind that only "reasonable" compensation is deductible by the corporation in computing its income tax. I.R.C. § 162(a)(1).

Arthur A. Adams	President	\$1,000 per month
Bernard B. Brooks	Vice President & Assistant Secretary ¹⁸¹	\$1,000 per month
Charles C. Carnes	Secretary ¹⁸² & Treasurer	\$100 per month

Each of the newly elected officers was present, accepted his office, and began the discharge of its duties.¹⁸³

5. *Minute Book.* The Secretary presented a Minute Book of the Corporation containing a copy of the Articles of Incorporation and Bylaws approved by the meeting. On motion duly made, seconded and unanimously adopted, it was:

RESOLVED that (1) the Minute Book presented to this meeting by the Secretary is approved and adopted, and the action of the Secretary in copying or inserting in it the Articles of Incorporation and the Certificate of Incorporation¹⁸⁴ and the Bylaws, is ratified and approved, and

(2) the Secretary is instructed to authenticate the Minute Book, to retain custody of it, and to insert in it the minutes of this meeting and of other proceedings of the shareholders, directors, and executive committee.¹⁸⁵

6. *Seal.* The Secretary presented a form of corporate seal designed in accordance with Bylaw 8.06. On motion duly made, seconded and unanimously adopted, it was:

(ABC CORP.) RESOLVED that the corporate seal, an impression of
(Corporate) which appears on the margin of these minutes is approved
(Seal) and adopted.¹⁸⁶
(Texas)
(19__)

181. Assistant secretaries are convenient for applying the corporate seal and attesting corporate documents when the secretary is absent. A person may hold two or more offices subject to the limitation of TBCA 2.42(A) (1956) and any that may be contained in the bylaws.

182. Frequently the corporation's attorney is the secretary since the latter has responsibility for formal legal acts such as preparing minutes and attesting documents. The attorney's willingness to be a corporate officer or director will depend on a number of factors, including his awareness of potential liabilities of such persons under statutes and at common law. See C. ISRAELS, CORPORATE PRACTICE § 9.02 (3d ed. 1974).

183. This recitation helps to preclude technical arguments over when (or whether) a person became an officer (e.g., at time of election, at time of qualification, or at some other time).

184. Copying the articles and certificate of corporation is recommended for convenience and completeness. The originals, of course, may be inserted, but they are usually kept separate and in the attorney's files.

185. TBCA 2.44(A) (Supp. 1975) and Bylaws 3.13, 6.08(a) require that minutes be kept for shareholders' as well as for directors' proceedings. It is customary that the same book be used for both. Minutes of committees may be included if desired, or if required by the bylaws or the resolutions establishing the committees. See note 119 *supra* and accompanying text.

186. A seal is permitted by TBCA 2.02(A)(3) (Supp. 1975). It is usually employed on stock certificates and conveyances of land, but is not required by law for either. TBCA 2.19(A) (Supp. 1975); TBCA 5.08 (1956). Practically, it is often easier to have a seal than to convince title companies, banks, et al. that there is no need for one. It may be convenient for each secretary and assistant secretary to have his own machine for applying the seal. The seal is affixed to the minute book for purposes of identification. The words on the seal are not prescribed by statute although they may be by bylaws. The language given here is typical. See Bylaw 8.06.

7. *Certificates.* The President presented a form of certificate designed in accordance with Bylaw 7.01 to be used to represent shares to be issued by the Corporation. On motion duly made, seconded and unanimously adopted, it was:

RESOLVED that the form of stock certificate (a copy of which is attached to these minutes) is approved and adopted.¹⁸⁷

8. *Issuance of Initial Shares.* Mr. Carnes stated that the Corporation had received the following offers¹⁸⁸ (accompanied by written investment representations satisfactory to Mr. Carnes as counsel to the Corporation¹⁸⁹) to pur-

187. For a form of common stock certificate and the rules governing it see notes 247-68 *infra* and accompanying text. If there are to be other securities (such as preferred stock, warrants or convertible notes) certificates or forms for them should be adopted by resolution of the directors. Sample forms are included in the text accompanying notes 271-435 *infra*.

188. An offer for shares must be in writing to constitute a subscription. TBCA 1.02 (A)(5) (1956). This formality is often dispensed with in closely held companies. If the offer is a subscription, it should be so described in the minutes. See TBCA 2.14 (1956) for details concerning subscriptions. See also note 60 *supra* and accompanying text.

For discussion of procedures for issuing securities other than common stock see notes 271(B) (preferred stock), 328(C) (warrants), 358(C) (convertible notes) *infra*.

189. (A) *U.S. Securities Law—General.* Every share (or other security) offered or sold must comply with at least two kinds of securities laws: (1) antifraud, considered in ¶¶ (D), (F) *infra*, and (2) registration-or-exemption. If the mails or interstate instrumentalities are used, it is unlawful to sell an unregistered security. Securities Act of 1933, § 5, 15 U.S.C. § 77e (1970). A number of exemptions from registration are allowed. For the small or closely held company, the most important are for private or small offers and for intrastate offers. These are considered in ¶¶ (B)-(C) *infra*. Since registration is slow, irksome and expensive, and the exemptions are technical and annoying, many small companies tend to ignore the securities laws, or at least the registration-or-exemption provisions. The tendency is reinforced by the realization that government enforcement activities are rarely aimed at small companies unless they offer securities to large numbers of persons or in fraudulent ways. But this does not mean that the securities laws can be safely ignored. There is always the risk that buyers of the securities will sue the company and its officers and directors under the express civil liabilities for failure to register. *Id.* §§ 12(1), 15, 15 U.S.C. §§ 77l(1), 77o (1970). In this kind of suit, the burden of proof of exemption is on the defendants with respect to all buyers and all offerees of the securities, and is rarely satisfied. See Henderson v. Hayden, Stone Inc., 461 F.2d 1069 (5th Cir. 1972); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971); Lively v. Hirschfield, 440 F.2d 631 (10th Cir. 1971).

(B) *U.S. Private or Small Offer.* The private offer exemption is loosely stated as "transactions by an issuer not involving any public offering." Securities Act of 1933, § 4(2), 15 U.S.C. § 77d(2) (1970). It has been frequently construed by the courts and the SEC, usually in an increasingly restrictive fashion. See, e.g., Meer, *The Private Offering Exemption Under the Federal Securities Act—A Study in Administrative and Judicial Contraction*, 20 Sw. L.J. 503 (1966). More recent language, particularly in the 5th Circuit, seems to make the bare statutory exemption almost unusable. See, e.g., SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972). Some relief has been provided since 1974 by SEC Rule 146, 17 C.F.R. § 230.146 (1974), which permits sales to 35 or fewer buyers without dollar limits, if a number of other conditions are met. The conditions include: (1) no general advertising (such as newspaper, radio and promotional seminars); (2) buyers capable of evaluating the risk of the purchase (and in some cases, capable of bearing the risk of total loss); (3) extensive information furnished to the buyers; and (4) restrictions on resale of the securities. The conditions are too complex for analysis here. The recitations in the text accompanying notes 189, 202, 205, 207, 264, 428 and 435 are aimed at reinforcing the company's claim for exemption under rule 146. But they do not by themselves assure it. For additional practical measures see Bromberg, *Private Offering Checklist*, 7 REV. SEC. REG. 867 (1974). Rule 146, while welcome for the problems it solves, has been criticized severely in other respects. See Kripke, *SEC Rule 146: A "Major Blunder,"* N.Y.L.J., July 5, 1974, at 1, col. 3. Its requirements of risk-analyzing and risk-bearing abilities of buyers make it inapplicable to many new companies which seek financing from friends and associ-

[note 189 cont'd]

ates. Rule 146 by its own terms does not exhaust § 4(2), and leaves some room for a claim under the statute but not under the rule. Doubt exists about the dimensions and character of that room. See generally Duff & Fisher, *Exemption to Private Offering Outside Rule 146*, N.Y.L.J., Jan. 29, 1975, at 1, col. 3; *id.*, Jan. 30, 1975, at 1, col. 1; *id.*, Jan. 31, 1975, at 1, col. 1. In 1975 a small offer exemption was granted under U.S. Securities Act of 1933, § 3(b), 15 U.S.C. § 77c(b) (1970). This is by way of SEC Rule 240, 17 C.F.R. § 230.240 (1974), which permits sales up to \$100,000 in 12 months if a number of other conditions are met. The conditions include: (1) no general advertising; (2) no commissions for soliciting buyers or selling the securities; (3) no more than 100 security holders of the company after the sale; (4) restrictions on resale; and (5) notifying the SEC of the sale. The conditions are simpler than those of rule 146 but still are too complex for analysis here. The recitations in the text accompanying notes 189, 202, 205, 207, 264 and 435 are aimed at reinforcing the company's claim for exemption under rule 240 too. Although they do not by themselves assure it, they come much closer than for rule 146, since rule 240 does not have the risk-analyzing and risk-bearing requirements of rule 146. Nor does rule 240 have the massive information requirements of rule 146. But the antifraud provisions require disclosure of all material information. See ¶ (D) *infra*. Most new or small companies should be able to live comfortably with rule 240 if \$100,000 is enough and if they can get it without brokers or finders who expect compensation. Additional constraints on the size and scope of the offering may be imposed by state securities laws (¶ (E) *infra*) and by entirely different kinds of law. For example, the company may not have more than 15 shareholders and still qualify for "close corporation" status under Texas law. See note 21 *supra*. It may not have more than 10 shareholders and still qualify for subchapter S federal income taxation. See note 204(C) *infra*.

(C) *U.S. Intrastate Offer*. "Any security which is part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory," is exempt from registration by Securities Act of 1933, § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1970). Many of the limitations are apparent from the statutory language. Others have developed in the process of interpretation. A recent implementation, SEC rule 147, 17 C.F.R. § 230.147 (1974), is designed to provide a "safe harbor." Like rule 146, it is stringent and not always helpful. See Kant, *SEC Rule 147—A Further Narrowing of the Intrastate Offering Exemption*, 30 BUS. LAW. 73 (1974). Precautions for the intrastate exemption include obtaining residence representations from buyers and restricting out-of-state resales. The forms in the text do not include any provisions aimed particularly at this exemption.

(D) *U.S. Antifraud*. The antifraud provisions apply whether or not a sale is exempt from registration, so long as there is some use of the mails or interstate instrumentalities (including, by the majority view, local telephones) in connection with the sale. Few transactions can be structured to avoid these provisions. They require disclosure of all material information to the buyers, on pain of civil liability (in a suit by the buyer) and various governmental sanctions. Civil liability is expressly created by Securities Act of 1933, § 12(2), 15 U.S.C. § 77l(2) (1970). Even farther-reaching civil liability has been implied under SEC rule 10b-5, 17 C.F.R. § 240.10b-5 (1974). See generally A. BROMBERG, *SECURITIES LAW: FRAUD* (1974). The most material information about a new company is likely to be its financial and business condition and plans, and its management. Cheap stock for insiders and other conflict of interest transactions are likely to be material too. See note 206(B) *infra*. In particular, the restrictions on resale of securities issued in a private offering are material and need to be disclosed fully to avoid violation of the securities fraud provisions. See SEC Securities Act Release No. 5226 (Jan. 10, 1972), [1971-72 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,483.

(E) *Texas Registration-or-Exemption*. Like federal law, Texas law requires registration or exemption for an offer or sale within the state. Texas Securities Act § 7, TEX. REV. CIV. STAT. ANN. art. 581-7 (1964). There are two exemptions specially designed for new and small companies. The first permits sales so long as the company has no more than 35 security holders after the sale, and does not use public solicitation (similar to general advertising, ¶ (B) *supra*). *Id.* § 5(I)(a), art. 581-5(I)(a). The second permits additional sales to 15 or fewer buyers in 12 months if several other conditions are met. The conditions are: (1) no public solicitation; (2) buyers buy for their own account and not for distribution; and (3) advance notice is filed with the Securities Commissioner. *Id.* § 5(I)(c), art. 581-5(I)(c). There are no dollar limits on either exemption. Both exemptions are relatively easy to use and should ordinarily be supported by transfer restrictions and ample information to buyers. See generally Bromberg, *Texas Exemptions for Small Offerings of Corporate Securities*, 18 SW. L.J. 537 (1964); Bromberg, *Texas Exemptions for Small Offerings of Corporate Securities—The Prohibition on Advertisements*, 20 SW. L.J. 239 (1966); Texas State Securities Board, Interpretation (Sept. 18, 1970), 3 CCH BLUE SKY. L. REP. ¶ 46,639. The Interpretation is analyzed

chase 500 shares of its authorized shares at a consideration of \$4 each:

Mr. Adams	225 shares	\$900 cash tendered
Mr. Brooks	225 shares	\$900 property delivered (office equipment, supplies and other property itemized on a list dated _____, 19__ and submitted to the President) ¹⁹⁰
Mr. Carnes	50 shares	\$200 labor done (attorney's services in the incorporation and organization of the Corporation) ¹⁹¹

On motion duly made, seconded and unanimously¹⁹² adopted, the foregoing offers were accepted¹⁹³ and it was:

RESOLVED that (1) 500 of the Corporation's authorized shares be issued¹⁹⁴ for a consideration of \$4 each,¹⁹⁵ consisting of money paid, labor done and necessary to the corporation, or property actually received,¹⁹⁶ and valued in the judgment of the directors¹⁹⁷ as follows:

in context in Lebowitz, *Corporations, Annual Survey of Texas Law*, 26 Sw. L.J. 86, 130-38 (1972). There is civil liability for failure to register if there is no applicable exemption. Texas Securities Act § 33(A)(1), TEX. REV. CIV. STAT. ANN. art. 581-33(A)(1) (1964).

(F) *Texas Antifraud*. There is a broad general antifraud provision and an express civil liability for fraud. *Id.* §§ 29(C), 33(A)(2), arts. 581-28(C), 581-33(A)(2). Neither has been construed as frequently as the federal analogues (§ (D) *supra*) but both seem to require the disclosure of all material information.

190. A moderately detailed description of the property and labor is appropriate in view of the stringencies of the TBCA and the Texas Constitution. See TEX. CONST. art. XII, § 6; TBCA 2.16(A) (Supp. 1975); note 139 *supra* and accompanying text. Typographically and logically it is better to insert it here, although it might appear in the resolution itself. Equivalent corporate results can be obtained by having the corporation issue its shares for money, then use the money to buy the property and pay for the labor. This is particularly desirable where the consideration is pre-incorporation legal services. An opinion by the Texas Attorney General states (on irrelevant authority) that such services are not proper consideration for the issuance of shares. TEX. ATT'Y GEN. OP. NO. V-156 (1947). TBCA 2.18(A) (Supp. 1975) expressly authorizes payment in money. Inferentially it may authorize payment in shares. Income tax results may differ, however. See I.R.C. § 351. See also 23 Sw. L.J. 820, 828-31 (1969) (on consideration for shares); note 198 *infra*.

191. See note 190 *supra*.

192. The remarks in note 178 *supra* concerning "interested" directors are relevant here too.

193. If the offers are subscriptions (note 188 *supra*), the acceptance should be embodied in a resolution rather than left to the narrative. See TBCA 2.14(C) (1956).

194. Many draftsmen feel more comfortable if "fully paid and nonassessable" is inserted here. TBCA 2.16(A) (Supp. 1975) renders this unnecessary. The phrase is usually included in the stock certificate. See note 251 *infra* and accompanying text. TBCA 2.16(A) (Supp. 1975) specifies that a share is "issued" in the statutory sense when the proper consideration is paid. Thus the delivery of a certificate is merely physical evidence of the issuance.

195. The directors may fix any consideration not less than par value. TBCA 2.15(A) (1956). If the shares are no-par, TBCA 2.15(B) (1956) governs. There is no statutory requirement that the consideration be the same for all shares, but this is often a practical necessity (to avoid fiduciary breach or buyer discontent) at least as to shares simultaneously issued. On the general authority of directors to issue shares see note 137 *supra* and accompanying text.

196. The type of consideration is specified by both the Texas Constitution and TBCA. See TEX. CONST. art. XII, § 8; TBCA 2.16(A) (Supp. 1975). The resolution follows the statutory language as closely as possible. See also TBCA 2.16(B) (1956); Bylaw 7.03(1); notes 139, 190 *supra*.

197. This recitation is designed to obtain the benefits of TBCA 2.16(C) (1956) (giving conclusiveness to the directors' valuation in the absence of fraud). See Bylaw 7.03 (2). The directors should have a reasonable basis for the valuation.

<i>To be issued to</i>	<i>Shares</i>	<i>Consideration</i>	<i>Value</i>
Arthur A. Adams	225	Money paid ¹⁹⁸	\$900
Bernard B. Brooks	225	Property actually received ¹⁹⁹	\$900
Charles C. Carnes	50	Labor done ²⁰⁰	\$200
	<u>500</u>		<u>\$2,000</u>

(2) of the \$4 consideration received for each such share, \$1 shall constitute stated capital and \$3 shall constitute capital surplus.²⁰¹

(3) the certificates shall bear a transfer restriction satisfactory to counsel for the Corporation and consistent with the buyers' investment representations.²⁰²

Payment of the consideration was thereupon made and accepted, and the certificates were executed, delivered and accepted.²⁰³

9. *Adoption of IRC 1244 Plan.* Mr. Carnes stated to the meeting the advantages of qualifying the company shares under Section 1244 of the Internal

198. (A) If the consideration has not yet been tendered in acceptable form, the issuance should be conditioned on proper tender. See TEX. CONST. art. XII, § 6; TBCA 2.16(B) (1956); Bylaw 7.03(1) (forbidding issuance of shares for promises of future payments or services); note 139 *supra*. Promissory notes received for shares are enforceable by the corporation if no shares are to be issued prior to payment. *Hatcher v. Jack Miller Milling Corp.*, 501 S.W.2d 439 (Tex. Civ. App.—Texarkana 1973), *error ref. n.r.e.*

(B) Recitation that property has actually been received is unavailing if, in fact, it has not been. *United Steel Indus. Inc. v. Manhart*, 405 S.W.2d 231 (Tex. Civ. App.—Waco 1966), *error ref. n.r.e.* (shares issued for property ordered cancelled). The same is true for shares issued for services if the services have not actually been performed. *Id.* (shares issued for past and future services, without allocation, all ordered cancelled).

(C) The corporation's tax basis for the property is not \$900 but an amount equal to Brooks' basis in the property before the transfer (subject to possible adjustment not necessary here). I.R.C. § 362(a). This same amount becomes Brooks' basis for the shares he receives from the corporation. I.R.C. § 358. Brooks has no taxable gain or loss on the transaction. I.R.C. § 351(a).

(D) The tax basis for Adams' shares is his \$900 cost. I.R.C. § 1011. The fair market value of the shares received by Carnes (which is not necessarily \$200) is ordinary income to him. I.R.C. § 351(a); Treas. Reg. § 1.351-1(a)(1), (a)(2) Ex. (3) (1975). Carnes' basis for the shares is this fair market value which is considered their cost. I.R.C. § 1011. These non-recognition and basis carryover results depend on the property transferors receiving "control" stock (*i.e.*, at least 80%). I.R.C. §§ 351(a), 368(c). If Carnes (or anyone else) receives more than 20% for services, the incorporation is taxable for all participants with the gain being ordinary or capital according to the type of property transferred.

(E) The corporation will treat the issuance of the service shares as an organizational expenditure of \$200. See I.R.C. § 248 (concerning the extent to which organizational expenditures may be amortized for tax purposes).

(F) The corporation has no taxable gain on the sale of the shares even though at a price above par. I.R.C. § 1032.

199. See note 198 *supra*.

200. *Id.*

201. TBCA 2.17(A) (1956) so provides. See TBCA 2.17(C) (1956) (directors may transfer additional amounts to stated capital). Although the matter is important, it is sometimes forgotten; therefore, recitation in the minutes may be useful. The statutory language is used. An accountant would say "\$1 shall be credited to stated capital."

202. See note 189 *supra*. For implementation see note 264 *infra* and accompanying text.

203. This is necessary to insure the validity of the I.R.C. § 1244 plan, which is effective only if, at its adoption, no portion of a prior stock offering is outstanding. I.R.C. § 1244(c)(1)(C).

Revenue Code of 1954.²⁰⁴ He noted that (subject to certain limitations) this Section permits ordinary (rather than capital) loss treatment (a) when an individual holder sells or exchanges his shares at a loss or (b) when they become worthless. It was agreed that this was a desirable feature to impart to the company's shares and that it would make the shares more attractive to potential purchasers. Mr. Carnes then presented the following plan.

IRC 1244 STOCK PLAN

(A) This plan shall become effective on adoption by the Board of Directors.

(B) The corporation is authorized to offer and issue under this Plan not

204. (A) There is no corporate necessity for an I.R.C. § 1244 plan, but it has significant income tax advantages for the individual investor (ordinary rather than capital loss up to \$50,000 a year for married taxpayers, on sale, exchange or worthlessness) if the company fails wholly or partly. I.R.C. § 1244(a); Treas. Regs. § 1.1244(a)-1(a) (1975). See generally B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 4.11 (3d ed. 1971); TAX MANAGEMENT PORTFOLIO No. 98, Small Business Stock. There is nothing to lose and much to gain from such a plan, and it should be seriously considered in every newly formed eligible corporation. Unlike subchapter S (I.R.C. § 1371-77, ¶ (c) *infra*), another small business tax relief provision, I.R.C. § 1244 is applicable to most types of businesses, regardless of the number of shareholders. There are, however, a number of limitations, most of which are embodied in the plan. See also I.R.C. § 1244; Treas. Regs. 1.1244(a)-1 thru 1.1244(e)-1 (1975). Corporate minutes may constitute a proper plan but they must be explicitly adopted. *Eger v. Commissioner*, 393 F.2d 243 (2d Cir. 1968); Rev. Rul. 66-67, 1966-1 CUM. BULL. 191. For examples which failed to qualify see *Anderson v. United States*, 436 F.2d 356 (10th Cir. 1971); *Godart v. Commissioner*, 425 F.2d 633 (2d Cir. 1970); *Childs v. Commissioner*, 408 F.2d 531 (3d Cir. 1969); *Bernard Spiegel*, 49 T.C. 527 (1968).

(B) The I.R.C. § 1244 plan may be adopted before the cheap stock is issued to management, but there is good reason not to do this. The fact that cheap stock is issued to management, even if only cash is recorded as consideration, raises at least the possibility that it is issued partly for services. If so, this would make it ineligible for I.R.C. § 1244 treatment since that provision, among other things, requires that the I.R.C. § 1244 stock be issued only for money or other property. I.R.C. § 1244(c)(1)(D); Treas. Regs. § 1.1244(c)-1(f) (1975). This might deprive not only the management but the outside investor of I.R.C. § 1244 benefits. Since management is typically buying at a nominal price, it acquires a nominal basis in its stock and has only a nominal tax loss on the stock if the business collapses. See note 198 *supra*. In this situation, the advantages management might obtain from I.R.C. § 1244 do not justify imperilling the much more substantial benefits the outside investor seeks. If management were making a large investment in the stock, and really needed I.R.C. § 1244 protection, adopting the plan before issuance of their shares might be worth the risk.

(C) *Subchapter S*. The advantages of subchapter S include tax exemption of the corporation and pass-through to the shareholders of the corporation's capital gain, ordinary income and net operating loss. The effect is similar to the tax treatment of partnerships, but by no means identical. Subchapter S is restrictive and technical in many ways. For example, there may be no more than 10 shareholders and only one class of stock. I.R.C. §§ 1371(a)(1), (4). The special tax treatment is terminated if stock is transferred to a holder who does not consent to continuation of subchapter S status, or if the corporation has passive investment income in excess of 20% of its gross receipts. I.R.C. §§ 1372(e)(1), (5). Pension and profit sharing plans of subchapter S corporations are subjected to the restrictions on sole proprietors and partners. I.R.C. § 1379(b). Because of the narrow applicability of subchapter S, it will not be considered further here, although it is well worth considering in particular situations where it might offer special advantages, such as tax shelter of individual income by corporate losses, or relief from double taxation when shareholders are in relatively low tax brackets. See generally B. BITTKER & J. EUSTICE, *supra* ¶ (A), at ch. 6; D. CRUMBLY, *ORGANIZING, OPERATING AND TERMINATING SUBCHAPTER S CORPORATIONS* (1970); I. GRANT, *SUBCHAPTER S TAXATION* (1974); I. SCHREIBER, *SUBCHAPTER S PLANNING AND OPERATIONS* (looseleaf, orig. pub. 1968); TAX MANAGEMENT PORTFOLIOS No. 178-2d, Subchapter S—Elections (1971); *id.* No. 60-5th, Subchapter S—Operations (1974).

more than 5,000 shares of common stock (par value \$1.00 per share) at such prices (not less than par value) as the Board shall determine.

(C) The corporation shall offer and issue shares under the Plan only while it is effective. The Plan shall be effective until two years, less one day, after the effective date unless sooner withdrawn or terminated by the Board.

(D) While the Plan is effective, the corporation shall not offer or issue any shares except under the Plan.

(E) The maximum amount to be received by the corporation in consideration of the shares to be issued under this Plan shall be \$499,000.

(F) Shares under this Plan shall be issued only for money or other property (other than stock or securities).

(G) The corporation shall use its best efforts in all relevant respects to qualify the shares offered and issued under this plan as "Sec. 1244 stock," as defined in the Internal Revenue Code and Regulations.

(H) This Plan shall be interpreted consistently with its intent to qualify under Sec. 1244 of such Code and Regulations.

— — — — —
The Board noted that no portion of any prior offering of shares was outstanding and that the corporation appeared to be eligible to adopt the Plan. Upon motion duly made, seconded and unanimously adopted, it was:

RESOLVED that (1) the IRC 1244 Stock Plan is adopted by the corporation and (2) the officers are authorized and directed to do all things necessary and appropriate to carry out the Plan.

10. *Issuance of IRC 1244 Plan Shares.* Mr. Carnes stated that the corporation had received an offer (accompanied by written investment representations satisfactory to Mr. Carnes as counsel for the Corporation²⁰⁵ from Elmer E. Ellis to purchase 250 shares of its authorized common stock for \$25,000 cash (\$100 a share) provided the shares be issued under an IRC 1244 Plan. On motion duly made, seconded and unanimously adopted, the offer was accepted and it was:

RESOLVED that:

(1) 250 of the Corporation's authorized common shares of common stock (par value \$1 per share) be issued for cash at \$100 each (total \$25,000) to Elmer E. Ellis;²⁰⁶

205. See note 189 *supra*.

206. Selling to Ellis at a much higher price than to the original three raises serious questions.

(A) Taxable income could be imputed to the original three purchasers if they received for their \$4 consideration shares that were actually worth \$100. The differential would be \$96 a share and it would be ordinary income. However, a single sale to Ellis at \$100 might be insufficient to establish this as the value of all the shares. There is usually a business necessity to give "insiders" a price advantage over outside investors in a new enterprise. There is little practical danger that the tax issue will be raised, but it cannot be ignored. See generally Herwitz, *Allocation of Stock Between Services and Capital in the Organization of a Close Corporation*, 75 HARV. L. REV. 1098 (1962).

(B) The insiders may have breached their fiduciary duty by selling to themselves at a cheaper price; however, there is no liability if they disclose the facts to the outsider in advance. The same is true for SEC Rule 10b-5 (nondisclosure of material information). See note 189(D) *supra*.

(2) of the consideration received for the share, \$1.00 shall constitute stated capital and the remainder shall constitute capital surplus;

(3) the certificates shall bear an investment restriction satisfactory to counsel for the Corporation and consistent with the buyer's investment representations;²⁰⁷ and

(4) the officers are authorized to issue additional shares to purchasers, on similar terms on payment of \$100 or more per share.²⁰⁸

11. *Commencing Business.* The President announced that the consideration of the value of at least \$1,000 had been received for the issuance of shares, and that consequently the Corporation was able to commence and transact business and incur indebtedness.²⁰⁹

12. *Bank Account.* The Treasurer presented a form of Resolution prepared by the _____ Bank for the establishment of a checking account. On motion duly made, seconded and unanimously adopted, it was:

[The bank's form (with blanks filled in) appears here, copied verbatim or physically inserted.]²¹⁰

[If bank's form is not copied, add:]

On motion duly made, seconded and unanimously adopted, it was:

RESOLVED that the foregoing bank account resolutions be evidenced in the Minute Book by insertion of properly completed portions of the printed form prepared by Bank.²¹¹

13. *Reimbursement.* Mr. Brooks presented an itemized statement of \$300 expenses and charges incurred by him, Mr. Adams and Mr. Carnes in the organization of the Corporation. On motion duly made, seconded and unanimously adopted, it was:

RESOLVED that (1) the \$300 expenses and charges of organization itemized by Mr. Bernard B. Brooks are reasonable, and

(2) the expenses shall be reimbursed and the charges shall be paid by the Treasurer from funds of the Corporation.²¹²

207. See note 189 *supra*.

208. Caution will be necessary to comply with the securities laws in the additional sales, for example, to avoid exceeding the numbers which permit exemption from the registration requirements. See note 189(B), (E) *supra*.

209. This paragraph is not required, but serves to designate the moment when: (a) the corporation is permitted to commence business by TBCA 3.05 (Supp. 1975) and 3.02 (A)(7) (Supp. 1975) and Articles of Incorporation ¶ 5; and (b) the directors' liability under TBCA 2.41(A)(5) (Supp. 1975) terminates. Of course, these events depend on the actual receipt of consideration (which is subject to challenge), not recitation.

210. The bank's form is usually a certificate for execution by the corporate secretary. If a copy is to be physically inserted in the minute book, the certifying language is often lined out or cut off. The form should be carefully scrutinized with respect to the authority it creates for signing or cashing checks, borrowing money, giving security, etc. Inappropriate portions should be eliminated in so far as the bank will permit. The blanks in the form should be carefully filled out so that there will be no doubt who is to exercise the authority given.

211. This resolution is unnecessary if the bank's form is recopied into the minute book.

212. The statute expressly allows "reasonable" expenses and charges to be paid out of the consideration received for shares. TBCA 2.18 (Supp. 1975). See I.R.C. § 248 concerning the extent to which organizational expenditures may be amortized for tax purposes.

14. *Pre-Incorporation Agreements.* The President described a contract that had been made for the acquisition of land by the Corporation. On motion duly made, seconded and unanimously adopted, it was:

RESOLVED that (1) the following instrument and its execution and delivery (by Bernard B. Brooks for and on behalf of the Corporation prior to its organization) are ratified, adopted, accepted, confirmed and approved²¹³ in all respects:

Contract, dated _____, 19__ with George G. Gordon for the sale by him to the Corporation of Blackacre [insert legal description] at a price of \$_____ payable \$_____ cash and \$_____ in monthly installments of \$_____, including interest at ____% on the unpaid balance.

(2) the officers of the Corporation are authorized and directed to execute and deliver for and on behalf of the Corporation all instruments necessary to perform the Contract, including a Promissory Note in the principal amount of \$_____ as described in the Contract, and a Deed of Trust of Blackacre to secure the payment of the Promissory Note.

15. *Attorneys.* On motion duly made, seconded and unanimously adopted, it was:

RESOLVED that Mr. Charles C. Carnes is appointed as General Counsel, and the firm of Carnes, Dawson and Evans (of Dallas, Texas) as attorneys to the Corporation, and that they shall be paid for their services at prevailing professional rates.²¹⁴

16. *Business in Other States.* On motion duly made, seconded and unanimously adopted, it was:

RESOLVED that (1) the Corporation shall qualify to do business in the States of _____ and _____,

(2) _____ is designated as agent in those States,

(3) the officers are authorized and directed to execute all instruments and take all actions necessary therefor and

(4) any specific resolutions required by those States are hereby adopted, may be certified by the proper officers, and shall be evidenced in the Minute Book by insertion of properly completed forms prepared by the States.²¹⁵

213. This redundancy of verbs may be justified by the conflict in theory concerning such agreements. See Comment, *Preincorporation Agreements*, 11 Sw. L.J. 509 (1957). Further protection to the individual who signed the contract may be afforded here by statements: (1) that the corporation does not consider him a party to the contract (this would help if a novation theory prevails), and (2) that the corporation will indemnify him for any liability he might incur in connection with the contract. See note 178 *supra* (regarding "interested" directors, as well as the fiduciary duties owing to the corporation).

214. This provision is probably unnecessary but will be comforting to lawyers. A similar provision is often included appointing accountants or auditors.

215. If foreign qualification is necessary to begin business operations, it should be authorized by the directors at the organizational meeting; otherwise there may be delays or illegalities. If the states' forms are available, verbatim adoption is preferable to the loose form of ¶ (4).

17. *Executive Committee.* On motion duly made, seconded and unanimously²¹⁶ adopted, it was:

RESOLVED that (1) Arthur A. Adams and Bernard B. Brooks are hereby designated as the Executive Committee²¹⁷ of the Corporation, and

(2) The Executive Committee shall have and may exercise all of the authority of the Board of Directors in the business and affairs of the Corporation,²¹⁸ except as specified in Bylaw 4.03.

18. *Fiscal Year.* On motion duly made, seconded and unanimously adopted, it was:

RESOLVED that the fiscal year of the Corporation shall be the year ending January 31.²¹⁹

19. *Directors' Fees.* On motion duly made, seconded and unanimously adopted, it was:

RESOLVED that each Director in attendance at any meeting of the Board shall receive a fee of \$_____ and his expenses of attendance.²²⁰

20. *Other Matters.* Mr. Carnes pointed out the need to operate the Corporation in accordance with law, particularly respecting withholding and unemployment taxes.²²¹ He advised the officers to obtain information and instruction from the Internal Revenue Service on these subjects.

216. A majority of all the directors (not merely of a quorum) is necessary to establish an executive committee. TBCA 2.36 (Supp. 1975); Bylaw 4.01.

217. An executive committee is authorized by statute if the bylaws or articles of incorporation so provide. TBCA 2.36 (Supp. 1975); Bylaw 4.01. Its members must all be directors of the corporation. The committee may consist of one or more members, depending on the bylaws. The bylaws may also establish qualifications for committee membership (e.g., that the president be a member). See Bylaw 4.02. On the advisability of an executive committee see note 109(C) *supra*.

218. This is authorized by statute if the bylaws or articles of incorporation or a governing resolution so provides. TBCA 2.36 (Supp. 1975). Bylaw 4.03 places limits, most of them required by statute, on the authority which can be given to an executive committee. See note 112 *supra* and accompanying text. The designation of an executive committee does not relieve directors of any responsibility imposed by law. TBCA 2.36 (Supp. 1975); Bylaw 4.13. If other committees (Finance, Audit, Compensation, etc.) are desired, they should be provided for in the bylaws, and implemented by resolutions parallel to this one for the executive committee. See note 109 *supra*.

219. The choice of a fiscal year is usually left to the directors, but may be made in the bylaws. See Bylaw 8.05. The fiscal year is important in several respects.

(A) It determines the company's accounting period for reporting to shareholders and others. See Bylaw 8.03.

(B) It normally determines when the annual meetings of shareholders and directors will be held, since this is shortly after the close of the fiscal year. See note 67 *supra* and accompanying text; Bylaw 3.08.

(C) It determines the company's tax year and the time for filing returns and paying tax. I.R.C. §§ 6072(b), 6012(a)(2), 6154. A new corporation is free to select any fiscal year. Treas. Reg. § 1.441-1(b)(3) (1975). Once the year has been chosen, it can be changed for tax purposes only with difficulty. I.R.C. § 442; Treas. Regs. 1.441-1(b)(4), 1.442-1 (1975).

Many businesses have a natural accounting year related to their seasonal patterns. Normally such a year should be chosen as the fiscal year.

220. According to the common law, authority for directors' fees must be found in the charter or bylaws. Fees are not customary in small corporations where the directors are also the officers. Fees may be provided for executive committee members if desired. See Bylaw 3.12.

221. Many new businesses fail to appreciate an employer's tax responsibilities. See, e.g., I.R.C. § 3403 (employer's liability for withholding taxes); I.R.C. § 6672 (100% penalty, often imposed on corporate officers personally).

21. *Adjournment.* Since there was no further business to come before the meeting, it was adjourned by unanimous agreement.

s/ Arthur A. Adams	s/ Charles C. Carnes
Arthur A. Adams, Director ²²²	Charles C. Carnes, Director and Secretary
<hr/>	
s/ Bernard B. Brooks	
Bernard B. Brooks, Director	

C. *Annual Meeting of Shareholders*²²³

_____, _____, 19__

1. *Convening of Meeting.* The annual meeting²²⁴ of the shareholders of ABC Corporation was convened in the offices of the Corporation at 1000 Texas Street, Dallas, Texas,²²⁵ at _____ m. on _____, _____, 19___. All the shareholders were present:²²⁶

Arthur A. Adams	225 shares
Bernard B. Brooks	225 shares
Charles C. Carnes	50 shares
Elmer E. Ellis	250 shares
	<hr/>
	750 shares

222. Unless the bylaws or resolutions provide otherwise, the secretary's signature is the only one required to identify the minutes. The other signatures are added to accomplish the waiver of call and notice, and to lend additional weight to the contents. Some further authentication is achieved by the practice of having the minutes of one meeting read and approved at the next, with an appropriate recitation that this was done. *See* note 164 *supra*.

223. (A) For general comments on minutes see note 163 *supra*.

(B) Minutes of shareholder meetings are required by TBCA 2.44(A) (Supp. 1975) and Bylaws 6.08(a), 8.02. They are usually kept in the same minute books as the minutes of directors' meetings. *See* note 185 *supra* and accompanying text.

224. An annual meeting is required by TBCA 2.24(B) (Supp. 1975) and Bylaw 2.02. For special meetings see TBCA 2.24(C) (Supp. 1975); Bylaw 2.04. A written instrument signed by all the shareholders is a valid substitute for a meeting. TBCA 9.10 (Supp. 1975); Bylaw 2.10. Telephone meetings may be held. TBCA 9.10(C) (Supp. 1975); Bylaw 2.11.

225. The time and place are set by Bylaws 2.01 and 2.02 pursuant to TBCA 2.24(A), (B) (Supp. 1975).

226. The holders of a majority of the shares entitled to vote constitute a quorum unless the articles of incorporation provide otherwise. TBCA 2.28 (1956); Bylaw 2.06. Unanimous attendance is not to be expected if there are more than a handful of shareholders. In such a case, there will probably be proxies, authorized by TBCA 2.29(C) (Supp. 1975) and Bylaw 2.08. The minutes would then list each shareholder present in person and each represented by proxy (showing the name of the proxy), together with the number of shares. If the number of shareholders is large (say, 50 or more) this procedure ceases to be practical. Instead, the same information should be compiled in separate records while the minutes recite only the total number of shares present in person and the total by proxy. Many other formalities may be observed at high levels of share dispersion or in the presence of opposition:

(A) reading of notice and call of meeting pursuant to TBCA 2.25 (1956) and Bylaw 2.05;

(B) affidavit of secretary or statement of transfer agent that notice was properly mailed to stockholders;

(C) announcement or certificate of availability of voting list compiled pursuant to TBCA 2.27 (1956) and Bylaw 2.03;

(D) closing of stock transfer books or fixing of record date by directors, in advance, pursuant to TBCA 2.26 (1956) and Bylaw 2.09;

(E) filing, inspection, and tabulation of proxies;

(F) announcement of quorum;

Each shareholder, by signing below, waived notice²²⁷ of the time and place of the meeting and the purposes for which it was held. Arthur A. Adams presided²²⁸ and Charles C. Carnes served as secretary.²²⁹

2. *Minutes of Previous Meeting.* The reading of the minutes of the last meeting of shareholders was waived by unanimous action.²³⁰

3. *Reports.*²³¹ The President, Mr. Adams, reported on the Corporation's business during the past year, emphasizing the growth in sales accompanied by higher costs and resulting in narrower profit margins. He was optimistic about the development of new territories. The Treasurer, Mr. Carnes, presented the financial statements for the last fiscal year.

4. *Ratification.*²³² All of the foregoing matters were fully discussed. On motion duly made, seconded and unanimously adopted, it was:

RESOLVED that all actions of the officers and directors during the year ended January 31, 19___, are hereby ratified and approved in all respects.

5. *Election of Directors.* On nomination and by unanimous vote,²³³ each of the following persons was elected²³⁴ a director until the next annual meeting of shareholders or until his successor is elected and qualified:

-
- (G) reading and approval of prior minutes;
 - (H) appointment of inspectors of election and administration of oath to them in writing;
 - (I) use of written ballots;
 - (J) written report of inspectors of election;
 - (K) announcement of results;
 - (L) attachment to minutes of documents mentioned above in (A), (B), (H), and (J);
 - (M) retention of documents mentioned above in (C), (E), (I);
 - (N) distribution of annual report (including financial statements) at or before the meeting.

See also Bylaw 2.12.

227. (A) Waiver of notice is permitted. TBCA 9.09 (1956); Bylaw 5.02. Unless waived, notice must comply with TBCA 2.25 (1956) and Bylaw 2.05. On the meager quality of notice requirements of state law see note 71 *supra* and note 237(A)-(C) *infra*.

(B) When full formality is appropriate, the board of directors typically passes a resolution: (A) calling the shareholders' meeting; (B) setting the time and place; (C) setting the record date (or closing the stock transfer books) to determine the persons entitled to notice and to vote; (D) nominating candidates for election to the board; (E) directing other matters to be put on the agenda; (F) authorizing the preparation of a proxy statement; (G) designating the persons to be named as proxies in the solicitation of shareholders; and (H) directing the mailing of notice and proxy statement.

228. Pursuant to Bylaw 6.06.

229. Pursuant to Bylaw 6.08.

230. This is customary in closely held corporations but not in others. See note 226 (G) *supra*.

231. Reports are customary for public relations purposes, but they are not required unless by: (A) bylaws (see Bylaw 8.03); (B) directors' action; (C) stockholder action pursuant to TBCA 2.38(C) (1956); or (D) federal laws and regulations applicable to certain publicly held companies. See note 156 *supra* and accompanying text.

232. This is something of a ritual. It has little or no effect unless the shareholders have full knowledge of the acts involved.

233. Whether voting is straight or cumulative depends on TBCA 2.29(D) (Supp. 1975) and the articles of incorporation. See Bylaws 3.06; notes 19-20 *supra* and accompanying text.

234. The number, term and method of election of the directors are determined by statute and articles or bylaws. See TBCA 2.32 (Supp. 1975)-2.33 (1956); Bylaw 3.02.

Arthur A. Adams
 Bernard B. Brooks
 Charles C. Carnes

6. *Adjournment.* Since there was no further business²³⁵ to come before the meeting, it was adjourned by unanimous agreement.

s/ _____ Charles C. Carnes

Charles C. Carnes,
 Secretary

Shareholders:²³⁶

s/ _____ Arthur A. Adams

Arthur A. Adams

s/ _____ Charles C. Carnes

Charles C. Carnes

s/ _____ Bernard B. Brooks

Bernard B. Brooks

s/ _____ Elmer E. Ellis

Elmer E. Ellis

235. (A) Besides the actions illustrated, there are relatively few matters which require shareholder action. The most important are charter amendment (TBCA 4.02 (Supp. 1975)—4.03 (1956 & Supp. 1975)), merger, consolidation or sale of assets (TBCA 5.03 (1956 & Supp. 1975), 5.10 (Supp. 1975)), dissolution (TBCA 6.03 (Supp. 1975)), and bylaw amendment (TBCA 2.23 (Supp. 1975), Bylaw 8.09). See note 28 *supra*. Shareholders may remove directors under the authority of TBCA 2.32 (Supp. 1975) and Bylaw 3.04. In these various matters, the method of voting is prescribed by statute, the articles of incorporation, and the bylaws. See, e.g., TBCA 2.28 (1956), 2.29 (1956 & Supp. 1975), 4.03 (1956 & Supp. 1975); text accompanying notes 16-18 *supra*; Bylaws 2.07-2.08.

(B) *Shareholder Management.* If the company is a "close corporation" with shareholder management the shareholders have a much broader range of authority and functions than depicted here. See notes 21 and 85(B) *supra* and accompanying text.

(C) *Shareholders Agreement.* If the company is a "close corporation" with a shareholders agreement, the agreement may designate the directors so that there will be no election. See note 85(B) *supra*. The minutes should probably state that named persons accepted their positions as directors (or continued in those positions) pursuant to the shareholders agreement dated _____, 19— on file with the corporation.

236. See note 222 *supra* and accompanying text.

237. (A) State law notice requirements vary with the type of meeting. For all meetings TBCA 2.25 (1956) and Bylaw 2.05 require notice to each voting shareholder of the time and place of the meeting. For special meetings these provisions require notice of "the purpose or purposes." For amendments of the articles TBCA 4.02(A)(2) (Supp. 1975) requires a copy of the proposed amendment or a summary of the changes to be effected. For mergers and consolidations TBCA 5.03(A) (1956) requires a copy or summary of the plan of merger or consolidation. For sale or other disposition of the corporate assets TBCA 5.10(A)(2) (Supp. 1975) requires a statement that a purpose of the meeting is to consider the proposed sale or disposition. For dissolution TBCA 6.03 (A)(2) (Supp. 1975) requires a statement that a purpose of the meeting is to consider the advisability of dissolving the company. See also Bylaws 3.04 (notice of intention to act on removal of a director), 8.09 (notice of proposed bylaw amendment), 5.01 (general provision on methods of giving notice).

(B) The striking thing about the state notice requirements is their total failure to call for information that would help a shareholder understand what he is voting on. He need be told nothing of the directors being elected, not their character or experience, not even their names. He need be told nothing of the economic background or impact of the transaction being proposed.

(C) The negligible notice requirements of state law are vastly augmented by federal law if the company has \$1,000,000 or more in assets and 500 or more shareholders of record, or is listed on a stock exchange. It then becomes subject to the Securities Exchange Act §§ 14(a), (c), 15 U.S.C. §§ 78n(a), (c) (1970), which require a proxy statement to shareholders if proxies are solicited, and an information statement if they are not. The content of the two statements is much the same and is very extensive. See SEC rules, schedules 14A, 14C, 17 C.F.R. §§ 240.14a-101, -103, -14c-101, 2 CCH FED. SEC. L. REP. ¶¶ 24,031-24,060, 24,220-24,225 (1974). The SEC Schedules are a useful guide to full and fair disclosure even where they are not mandatory. Following

D. Notice of Shareholders' Meeting²³⁷

_____, 19____

Dear Shareholder:

The annual²³⁸ meeting of the shareholders of ABC Corp. (for the election of Directors and the transaction of other business described in the accompanying Proxy Statement²³⁹) will be held at [time and place].

Whether or not you expect to attend the meeting, please sign and return the accompanying Proxy in the enclosed envelope. If you do come, you may vote your shares in person.²⁴⁰

By order of the Board of Directors:²⁴¹

Charles C. Carnes²⁴²

Secretary, ABC Corp.

E. Waiver of Notice²⁴³

_____, 19____

We, all the shareholders²⁴⁴ of ABC Corp., waive notice of the time, place and purpose²⁴⁵ of a meeting of shareholders at [time and place].

[Signatures]²⁴⁶

them should be helpful in sustaining the validity of actions taken if they are challenged under state law for fraud, fiduciary breach or other misconduct involving an element of nondisclosure. See also note 71 *supra*.

(D) Waiver of notice is permitted by TBCA 9.09 (1956) and Bylaw 5.02, and is widely used in closely held companies. See text accompanying note 227 *supra*; note 243 *infra*. Without proper notice or waiver, action taken at the meeting may be invalid.

238. Notice for a special meeting would be substantially the same, plus a statement of the purpose(s). See note 237(A) *supra*.

239. See note 237(C) *supra*.

240. This amounts to an agreement that the proxy is revocable, at least in the specified circumstance of personal shareholder attendance. Most proxies are revocable anyway. See note 79 *supra* and accompanying text. In a publicly held company, it is a nuisance to cull, at the last minute, proxies previously received from shareholders who now want to vote in person. But it is worth doing, both for good shareholder relations and for more effective proxy solicitation.

241. This is probably unnecessary for an annual meeting; it may be important for a special meeting which may be called by various persons. TBCA 2.24(C) (Supp. 1975); Bylaw 2.04.

242. The secretary is customarily charged with the duty of giving notice. See Bylaw 6.08(b). In a publicly held company, the notice is usually addressed and mailed by the transfer agent who maintains the shareholder records.

243. Waiver is permitted by TBCA 9.09 (1956) and Bylaw 5.02 and is widely used in closely held companies. It may be given either before or after the meeting, but it must be in writing. No particular form is required, and it is sometimes embodied in the minutes which are signed by the shareholders. See note 227 *supra* and accompanying text. The separate waiver has the advantage that it can be prepared in advance and signed at the meeting, without waiting for the preparation of formal minutes.

244. There is no requirement that all waiving parties sign the same piece of paper. Nor is there any requirement that all waive, if the rest are given notice. The same form can be used for meetings of directors by changing "shareholders" to "directors" in both places.

245. Time, place and purpose are the main ingredients of notice. See note 237(A) *supra*. Referring to all of them may strengthen the waiver against challenge. Often, however, these elements are not specified (e.g., the waiver is simply "notice of a meeting . . .").

246. Attendance at a meeting will normally constitute waiver of notice. See Bylaw 5.02.

247. (A) *General*. For corporate law purposes common stock is the basic ownership or equity security of the company, typically representing control through voting power and having a residual claim on assets through dividends or on dissolution. By one name or another, it is required in every corporation. Many attributes of common stock are specified by statute. See, e.g., TBCA 2.24 (Supp. 1975), 2.25 (1956), 2.28 (1956), 2.29 (1956 & Supp. 1975). Many requirements of the common stock certificate are similarly specified. See notes 249-64 *infra* and accompanying text. The number and kind of shares the company is authorized to issue must be stated in the articles of incorporation. TBCA 2.12 (1956 & Supp. 1975), 3.02(A)(4) (Supp. 1975). See note 9 *supra* and accompanying text.

(B) *Procedure*. Subject to the authorization in the articles mentioned in ¶ (A), shares of all kinds are normally issued by the board of directors. An executive committee or other committee can be given this function. See TBCA 2.36 (Supp. 1975); note 109(C) *supra*. The procedures for issuance of shares and the restrictions on type of consideration are illustrated in notes 188-203, 205-08 *supra* and accompanying text. The procedure for adopting a form of certificate is illustrated in the text accompanying note 187 *supra*.

(C) *Tax Treatment*. Most of the salient features of common stock are covered in notes 198(C)-(F), 204, 206(A) *supra*. Common stock is "stock or securities" for purposes of a taxfree incorporation under I.R.C. § 351 and a taxfree acquisition under I.R.C. §§ 354(a)(1) and 368(a)(1)(A). And it is voting stock for purposes of a tax-free acquisition under I.R.C. §§ 354(a)(1) and 368(a)(1)(B), (C). Dividends on common or preferred stock are not deductible by the company. In general they are ordinary income to the shareholders. I.R.C. § 61(a)(7). An individual shareholder can exclude \$100 of dividends from taxation. I.R.C. § 116. A corporate shareholder can exclude 85%. I.R.C. § 243(a).

(D) *Accounting Treatment*. The consideration received by the company for common or preferred stock is normally debited to an asset account (or an expense account if the consideration is services). An equal amount is normally divided between stated capital or common stock account (to the extent of par value of the shares issued) and capital surplus or capital in excess of par value (for the remainder). See note 201 *supra* and accompanying text. Expenses of issuing the stock are normally debited against the portion going to capital surplus or capital in excess. The common stock or stated capital account appears on the balance sheet, usually with the number of shares outstanding. Common stock is used in calculating earnings per share.

(E) *Securities Laws*. See note 189 *supra*.

(F) *UCC*. Common stock, like preferred stock, is a security under TEX. BUS. & COMM. CODE ANN. § 8.102(1) (Supp. 1975) and is therefore governed by the transfer and other provisions of article 8 of the UCC. TBCA 2.22(A) (Supp. 1975). See Bylaw 7.07 and note 147 *supra*.

(G) *Economic Character*. From an economic or investment viewpoint, common stock is the security that has the unlimited possibility of growth with the company, and is entitled to whatever is left after creditors and senior security holders are satisfied. To a great extent, then, the economic character of the common stock is shaped by the character of the senior securities. The common stock has its returns in the form of dividends (see notes 151-52 *supra* and accompanying text) and capital appreciation representing the growth of the company's residual earnings and assets to which it has a claim on dissolution.

(H) *Variables*. This is a relatively simple type of certificate, suitable only for common stock of a corporation which has no other class of stock. Even in this narrow context there are numerous variables. One is the rather trivial choice between par and nonpar. See 23 Sw. L.J. 831-32. Another is the setting of par value which is usually a nominal amount. See note 9 *supra* and accompanying text. A third is the number of votes per share. See note 16 *supra* and accompanying text. Other variables are considered in the remaining paragraphs of this note. State law imposes no requirement on the physical character of the certificate which may range from a simple typewritten sheet of ordinary paper to an elaborately engraved sheet of parchment. Most small companies use printed certificates with blanks for corporate name and seal, par value, holder's name, etc. These are often sold as part of a "corporation kit" which includes a seal and perhaps bylaws and organizational minutes. Such certificates need to be supplemented with special provisions like the pre-emptive rights denial and the transfer restriction in the text of this certificate and the various matters listed in the present note. If the certificate is to be traded on a stock exchange, the exchange typically prescribes additional requirements as to text and physical character. See, e.g., N.Y. STOCK EXCHANGE COMPANY MANUAL A-209 to -227 (1966).

IV. SECURITY CERTIFICATES OF ABC CORP.

A. *Common Stock Certificate*²⁴⁷Certificate # C _____²⁴⁸ _____ Shares

ABC Corp.

Incorporated Under the Laws of the State of Texas²⁴⁹

Common Stock

(I) *Transfer Restrictions*. If there are restrictions on transfer (e.g., in connection with a buy-sell agreement, or "close corporation" status), they must be noted conspicuously on the certificate. See note 264 *infra*.

(J) *Voting Agreement*. If the shares are subject to a voting agreement, this must be stated on the certificate. TBCA 2.30(B) (Supp. 1975).

(K) *Lien*. If the shares are subject to a lien in favor of the corporation this should appear on the certificate to bind third persons without actual knowledge. TEX. BUS. & COMM. CODE ANN. § 8.103 (1968). See Bylaw 7.05.

(L) *Shareholder Management*. If the articles provide for shareholder management, instead of director management of a "close corporation," the certificate must conspicuously so state, in language of this sort:

ARTICLE 14 OF THE ARTICLES OF INCORPORATION READS AS FOLLOWS: "SHAREHOLDER MANAGEMENT. SO LONG AS CORPORATION IS A CLOSE CORPORATION (AS DEFINED IN THE TEXAS BUSINESS CORPORATION ACT), ITS BUSINESS AND AFFAIRS SHALL BE MANAGED BY THE SHAREHOLDERS (WITH THE VOTES PER SHARE, QUORUM, PROXY, MAJORITY AND OTHER PROVISIONS APPLICABLE TO SHAREHOLDER MEETINGS OR ACTIONS) RATHER THAN BY A BOARD OF DIRECTORS."

See notes 21, 85(B) *supra* and accompanying texts.

(M) *Shareholders Agreement*. If there is a shareholders agreement governing a "close corporation" the certificate must conspicuously state, summarize or refer to the agreement; otherwise the agreement is not binding on a transferee without actual notice of the existence of the agreement. See TBCA 2.30-2(C) (Supp. 1975).

(N) *Depletion Dividends*. If the corporation desires to pay dividends out of depletion reserves under TBCA 2.39 (1956), the phrase "consuming assets corporation" must appear in its corporate name and on its stock certificates. TBCA 1.02(A)(17) (1956). The certificates must also state: "This corporation is permitted by law to pay dividends out of reserves which may impair its stated capital." TBCA 1.02(A)(17) (1956).

(O) *Optional Dissolution*. If the articles allow optional dissolution by shareholders, the certificate must conspicuously so state in full or summary form or by reference. TBCA 2.30-5(B) (Supp. 1975). If the provision in the articles is brief, it should be copied in full:

ARTICLE 15 OF THE ARTICLES OF INCORPORATION READS AS FOLLOWS: "DISSOLUTION. SO LONG AS THE CORPORATION IS A CLOSE CORPORATION (AS DEFINED IN THE TEXAS BUSINESS CORPORATION ACT), IT MAY BE DISSOLVED AT ANY TIME BY ANY SHAREHOLDER GIVING WRITTEN NOTICE TO THE OTHER SHAREHOLDERS IN ACCORDANCE WITH THE TEXAS BUSINESS CORPORATION ACT."

See note 22 *supra* and accompanying text.

(P) *Multiple Classes*. If the corporation has more than one class of shares, the front or back of the certificate must: (1) state all relative preferences, limitations and rights in full; or (2) state that the corporation will furnish without charge to any shareholder, on written request, a full statement of the relative preferences, limitations and rights, and that such a statement is on file in the office of the secretary of state. TBCA 2.19(B) (Supp. 1975). For an example of such a statement see text accompanying note 276 *infra*.

(Q) Additional requirements may be imposed by transfer agents, registrars or stock exchanges.

(R) No certificate may be issued until proper consideration has been paid for the shares. TBCA 2.19(D) (Supp. 1975). For what constitutes proper consideration see TBCA 2.15, 2.16 (1956 & Supp. 1975), and Bylaw 7.03. Once the consideration is paid the shares are legally issued, even though no certificate has been prepared or delivered. TBCA 2.16(A) (Supp. 1975).

(S) TBCA 2.44 (Supp. 1975) requires the keeping of shareholder records.

248. Although no longer required by law, some sort of numbering system for certificates is essential.

249. This is required by TBCA 2.19(C)(1), (3) (Supp. 1975).

This certifies that _____ is the owner²⁵⁰ of _____ shares of fully paid and nonassessable²⁵¹ Common²⁵² Stock (par value \$1) of ABC Corp., transferable only²⁵³ on the books of the corporation by the holder hereof in person or by attorney on surrender of this certificate²⁵⁴ properly indorsed.²⁵⁵

This certificate and the shares represented by it are issued and shall be held subject to all provisions of the Articles of Incorporation and the Bylaws of the corporation as amended from time to time (copies of which may be inspected at the offices of the corporation).²⁵⁶ The holder, by accepting this certificate, expressly assents to the same.²⁵⁷

In particular, this certificate and the shares represented by it are issued and shall be subject to Article 9 of the Articles of Incorporation which reads as follows:

"No shareholder or other person shall have any pre-emptive right whatsoever."²⁵⁸

Witness the seal²⁵⁹ of the corporation and the signatures of its authorized officers.²⁶⁰

Dated _____	[Seal] ²⁶¹	ABC CORP.
		By
_____	[Signature]	_____
	[Title]	[Signature] ²⁶²
		[Title]
Shares \$1 par value ²⁶³ each.		
[Restriction]		

250. This is required by TBCA 2.19(C)(2) (Supp. 1975). In certain foreign countries, certificates may be issued to "bearer" as may bonds and warrants in the United States.

251. This recitation is not invariably true. The reality depends on whether proper consideration has been paid. TBCA 2.16(A) (Supp. 1975); note 247(R) *supra*. However, the recitation may protect purchasers of the certificate.

252. See note 249 *supra*.

253. This is somewhat wishful too. See note 266 *infra*. The corporation can rely on record ownership for dividend and voting rights. See note 149 *supra* and accompanying text. See TEX. TAX-GEN. ANN. arts. 14.19-.21 (1969) (concerning limitations on transfer of stock held by a decedent; inheritance tax).

254. On lost certificates see note 146 *supra* and accompanying text.

255. On indorsement see note 266 *infra*.

256. This is a general and probably superfluous statement of the law. Some companies offer to mail copies of the articles and bylaws on request.

257. See note 256 *supra*.

258. A denial of pre-emptive rights must be by a provision in the articles of incorporation which appears on the certificate. See note 14 *supra* and accompanying text.

259. A seal, though commonly used, is not required; note the permissive language in TBCA 2.19(A) (Supp. 1975). Cf. TBCA 5.08 (1956) (explicitly dispensing with a seal for conveyances); note 186 *supra*.

260. TBCA 2.19(A) (Supp. 1975) and Bylaw 7.01 specify the officers authorized to sign, as well as the method of signature. These may be facsimile if there is a transfer agent or registrar.

261. See note 259 *supra*.

262. See note 260 *supra*.

263. This is required by TBCA 2.19(C)(4) (Supp. 1975). If the shares have no par value, substitute "No Par" or "Without Par Value." National Bank stock certificates sometimes contain this language with respect to par value: "The par value of the shares . . . is set forth in the Articles of Association [charter] of the bank and the amendments thereto, which are hereby expressly incorporated by reference." Instructions of Comptroller of the Currency, Apr. 15, 1941, PRATT FED. BANK. SERV. ¶ 486.5, at 486.7. Could such a provision be used under Texas law?

THESE SHARES HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933 OR UNDER ANY APPLICABLE STATE LAW. THEY MAY NOT BE OFFERED FOR SALE, SOLD, TRANSFERRED OR PLEDGED WITHOUT (1) REGISTRATION UNDER THE SECURITIES ACT OF 1933 AND ANY APPLICABLE STATE LAW, OR (2) AN OPINION (SATISFACTORY TO THE CORPORATION) OF COUNSEL (SATISFACTORY TO THE CORPORATION) THAT REGISTRATION IS NOT REQUIRED.²⁶⁴

[Common Stock Certificate (back side)]²⁶⁵

For value received I/we hereby sell, assign and transfer to

_____ of the shares

 (name of transferee) (number)
 represented by this certificate, and irrevocably appoint _____²⁶⁷

 (name of attorney)
 (with full power of substitution) to transfer the shares on the books of the Corporation.

Date _____

In the presence of _____

 (Please sign exactly as name
 appears on certificate)

 Taxpayer ID No.

 Signature guaranteed by:²⁶⁸

264. The restriction supports the private and small offering exemptions from federal and state securities registration. See note 189(B), (E) *supra*. Restrictions of this kind are authorized by TBCA 2.22(D)(3) (Supp. 1975).

To be effective under state law, a transfer restriction must be noted *conspicuously* on the face of the certificate. TEX. BUS. & COMM. CODE ANN. § 8.204 (1968) (unless noted conspicuously on the certificate, an issuer-imposed transfer restriction is ineffective except against a person with actual knowledge of it). See *Ling & Co. v. Trinity Savings & Loan Ass'n*, 482 S.W.2d 841, 843-44 (Tex. 1972) (conspicuousness requires something on the face of the certificate to attract attention). See TBCA 2.22(C), 2.19 (H) (Supp. 1975) (as amended 1973, codifying the *Ling* holding, and giving examples of conspicuousness which include capital letters, bold-face type and contrasting colors); Lebowitz, *Corporations, Annual Survey of Texas Law*, 27 Sw. L.J. 85, 96-102 (1973).

265. This form is not filled in until the owner of the certificate is ready to dispose of it in some way, for example by sale or gift, by pledge to a creditor, or by re-issue of new certificates to himself in different denominations. No particular form is required but this one is widely used.

266. Indorsement is the owner's signature at the end of this form or at the end of a separate stock power of the kind in the text accompanying note 270 *infra*. TEX. BUS. & COMM. CODE ANN. § 8.308(a) (1968). The name of the transferee is usually filled in when the transferor and transferee are dealing directly with one another, as is typical in a closely held company. This constitutes a special indorsement. *Id.* § 8.308(b). The name of the transferee is usually left blank when the transferor is selling through a broker, as is typical for a publicly held security. This constitutes an indorsement in blank and essentially makes the security transferable to or by the bearer. An indorsement of either kind does not transfer the security until the certificate is delivered. *Id.* § 8.309. Although delivery plus indorsement normally will effect a transfer between transferor and transferee, registration of the transfer by cancelling the old certificate and issuing a new one in the transferee's name is necessary to record the transferee as a security holder on the corporation's books and entitle him to dividends, notices, etc. See notes 147-49 *supra* and accompanying text.

267. The "attorney" need not be a lawyer. He is usually the transferee or his agent in a transaction involving a closely held security. He is usually the transferor's broker in a transaction involving a publicly traded security. In either case, the space can be left blank without impairing the transaction. Naming an attorney restricts the bearer quality of an indorsement in blank, since only that attorney (or his substitute) can properly give instructions for registration of transfer of the security. This procedure provides some safeguard against loss or theft.

268. On signature guarantees see Bylaw 7.07(b) and TEX. BUS. & COMM. CODE ANN.

[Stub of Certificate Book]²⁶⁹

1. ISSUANCE:

Certif. No. _____ Shares _____ Date _____
 Name _____
 Address _____

 Taxpayer ID no. _____

2. SOURCE (from whom transferred):

Certif. No. _____ Shares _____ Date _____
 Name _____
 Disposition of shares not issued in this certificate: _____

3. DISPOSITION (to whom transferred):

Certif. No. _____ Shares _____ Date _____
 Name _____
 Certif. No. _____ Shares _____ Date _____
 Name _____
 Certif. No. _____ Shares _____ Date _____
 Name _____

[Separate Stock Power]²⁷⁰

For value received, I/we hereby sell, assign and transfer to

_____ of the shares of
 _____ (name of transferee) _____ (number)
 _____ stock of _____ represented
 _____ (class) _____ (name of corporation)
 by certificate(s) No.(s) _____ standing in
 my/our name(s) on the books of the corporation, and irrevocably constitute
 and appoint _____ attorney (with full power
 _____ (name of attorney)

§§ 8.402, 8.312 (1968). A closely held company will often waive guarantee of signature.

269. For a closely held company, the stubs of the stock certificate books are an important record which is often poorly kept. The forms in the text call for more information than those in the typical printed book of stock certificates. A publicly held company normally computerizes this kind of information.

270. A stock power separate from the certificate is authorized by TEX. BUS. & COMM. CODE ANN. § 8.308(a) (1968). A separate power does not effect transfer until delivered with the certificate. See note 266 *supra*. A separate power is convenient in many situations, for example: (1) a pledge of stock that is intended to be temporary, thus not justifying an indorsement on the certificate; or (2) a separate transmittal of the certificate and the stock power to reduce the risk of theft which would be much greater if both documents were together. Notes 265-68 *supra* are applicable to the corresponding parts of the separate stock power.

of substitution) to transfer the shares on the books of the corporation.

Date _____

In the presence of _____

Transferor's Taxpayer ID No.

Signature guaranteed by:

271. (A) *General*. For corporate law purposes, preferred stock is considered an ownership or equity security of the company. But, depending on how it is written, it may have very little resemblance to common stock, which is the true equity security. Typically it has neither of the principal features of common stock: significant voting power and an unlimited residual claim on assets. See notes 285, 293 *infra* and accompanying text. There is no need for a company to have preferred stock, and the unattractive features of preferred stock make it an unwise security to issue in most instances. See ¶ (G) *infra*. Preferred stock is authorized by statute. TBCA 2.12, 2.13 (1956 & Supp. 1975). But the number and kind of preferred shares the company is authorized to issue is largely a matter of drafting. The provisions must be in the articles of incorporation, except for those the directors can fix by resolution for series preferred. TBCA 2.12, 2.13 (1956 & Supp. 1975), 3.02(A)(4) (Supp. 1975). See note 276 *infra* and accompanying text for a single class of preferred shares; note 298 *infra* and accompanying text for a class of preferred issuable in series. Numerous requirements of the preferred stock certificate are treated in notes 272-96 *infra* and later in this note. Notes 248-64 *supra* on common stock certificates are generally applicable to the corresponding parts of the preferred stock certificates, and should be consulted. The preferred stock provisions in the text accompanying notes 276-97 *infra* are rather agglutinative. More atomized and better labelled provisions for preferred stock will be found in the text for series preferred accompanying notes 298-327 *infra*. See generally Buxbaum, *Preferred Stock—Law and Draftsmanship*, 42 CALIF. L. REV. 243 (1954), reprinted in DRAFTING OPINIONS AND CORPORATE INSTRUMENTS 141 (Research & Documentation Corp. ed. 1971).

(B) *Procedure*. Procedure for the issuance of preferred stock, and the consideration required for it, are essentially the same as for common stock. See note 247(B) *supra* and references there. The only significant difference is the authority of the directors to set the major terms of preferred stock issued in series. See note 299 *infra* and accompanying text.

(C) *Tax Treatment*. The tax features of preferred stock are substantially the same as common. See note 247(C) *supra* and references there. However, voting rights only on default of dividends are probably insufficient to qualify for "voting stock" which can be used in a taxfree acquisition under I.R.C. §§ 354(a)(1) and 368(a)(1)(B), (C). See note 293 *infra*. Preferred stock issued as a stock dividend or in certain reorganizations is "section 306 stock" with ordinary income consequences on sale or redemption. I.R.C. § 306.

(D) *Accounting Treatment*. See note 247(D) *supra*.

(E) *Securities Laws*. See note 189 *supra*.

(F) *UCC*. See note 247(F) *supra*.

(G) *Economic Character*. From an economic or investment viewpoint, the typical preferred stock is only: (1) an income stream of expected dividends in fixed amounts; and (2) a possibility of repurchase or redemption by the company at a fixed price. The income stream is subject to the discretion of the directors, as well as legal limits in terms of available surplus. See note 277 *infra* and accompanying text; Bylaw 8.01. It is therefore considerably less certain than the income stream from a debt security. The possibility of repurchase or redemption depends also on director discretion and financial condition. See note 286 *infra*. It is therefore considerably less certain than the payback of a debt security. Without the chance of either increased dividends or an increased claim on assets, the preferred shareholder has no prospect of capital appreciation, except perhaps in limited amounts if the market rates of dividend or interest decline below the level stated in his security. But he has an unlimited downside risk if the company fails. For these reasons, he ordinarily insists on a high rate of income (dividend), comparable

B. Preferred Stock Certificate²⁷¹

Certificate #P _____ Shares _____

ABC Corp.

Incorporated Under the Laws of the State of Texas

6% Preferred Stock (\$25 Par Value)

Cumulative, Redeemable, Nonparticipating, Nonconvertible

This certifies that _____ is the owner of _____ shares of the fully paid and non-assessable 6% Preferred Stock (par value \$25) of ABC Corp., transferable only on the books of the corporation by the holder hereof in person or by attorney on surrender of this certificate properly indorsed.

A full statement of all the designations, preferences, limitations and relative rights of the shares of each class of shares which the corporation is authorized to issue appears on the back of this certificate.²⁷²

This certificate and the shares represented by it are issued and shall be held subject to all provisions of the Articles of Incorporation and the Bylaws of the corporation as amended from time to time (copies of which may be

to the interest on a debt. From the company's position, dividends are not deductible by the company in computing federal income tax, while interest is. In some instances, a redemption of the preferred would be a taxable, ordinary income dividend to the holder, rather than a purchase of stock or a payback of debt. See I.R.C. § 302. In short, the tax laws and the investment characteristics normally combine to make preferred stock unappealing to the company, to the investor, or to both. The only significant attraction to the company is that funds raised by preferred stock do not have to be repaid unless the company chooses to redeem. However, there are instances in which preferred stock is or can be made attractive enough to the buyer to justify its issuance by the company. Principal examples are: (1) participating or convertible preferreds which have the potential for capital appreciation with the fortunes of the company (see notes 280, 363 *infra*); (2) voting preferreds designed to permit taxfree corporate acquisitions under I.R.C. §§ 368(a)(1)(B), (C) and provide a higher income stream to the former holders of the acquired company than is feasible or desirable for holders of the acquiring company; (3) traditional preferreds offered to give some investors a senior position without making the company's debt-equity ratio excessive for tax or borrowing purposes; (4) traditional preferreds offered to give retiring or dying common shareholders or their families a senior and more generous income, by exchanging preferred for common, without the tax resulting from an exchange of debt for stock; and (5) traditional preferreds designed for corporate investors who are content with fixed income streams and who will benefit from being taxed on only 15% of the dividends (see I.R.C. § 243 and note 247(C) *supra*).

(H) *Variables*. The choice between par and nonpar stock, and the setting of par value if there is to be one, are subject to the same legal constraints as for common stock. See note 247(H) *supra*. But tradition and other law combine to set the par value at or near the price at which the stock is to be sold and the price at which it may be redeemed. See notes 284, 286 *infra*. Voting rights are usually quite limited, but need not be. See note 293 *infra* and accompanying text. Many other variables in preferred stock are discussed in notes 272-327 *infra*.

(I) Note 247(I)-(S) *supra* applies equally to preferred and common stock.

272. TBCA 2.19(B) (Supp. 1975) requires that the front or back of the certificate: (1) state all relative preferences, limitations and rights in full; or (2) state that the corporation will furnish without charge to any shareholder, on written request, a full statement of the relative preferences, limitations and rights, and that such a statement is on file in the office of the secretary of state. The first alternative has the advantage of being self-contained. The second alternative has the advantage of facilitating changes in the relative preferences, etc. (by amendment of the articles, or issuance of additional classes of shares by the directors if they are authorized to do so) and avoiding the difficult question whether the old certificates need to be replaced to show the changed preferences. More importantly, the second alternative avoids the illegibility which usually results from trying to fit the lengthy provisions onto the back of a standard sized certificate. Publicly held companies almost invariably opt for the second alternative.

inspected at the offices of the corporation). The holder, by accepting this certificate, expressly assents to the same.

In particular, this certificate, and the shares represented by it, are issued and shall be subject to Article 9 of the Articles of Incorporation which reads as follows:

"No shareholder or other person shall have any pre-emptive right whatsoever."

This certificate is not valid unless countersigned by the transfer agent and registered by the registrar.²⁷³

Witness the seal of the corporation and the signatures of its authorized officers.

Dated _____ [Seal]	ABC Corp.
_____ [Facsimile signature]	By _____ [Facsimile signature] ²⁷⁴
Secretary	President
Registered: _____ Bank	Countersigned: _____ Bank ²⁷⁵
Registrar	Transfer Agent
by _____	by _____
Authorized Signature	Authorized Signature

[Preferred Stock Certificate (back side)]

Statement of All the Designations, Preferences, Limitations,
and Relative Rights of the Shares of
ABC Corp.²⁷⁶

273. Transfer agents and registrars are practical necessities for publicly held companies. They are not required by corporate law, but are required by the rules of most stock exchanges on which the securities are traded. A transfer agent typically handles the issuance of the corporation's new shares and the registration of transfer of its outstanding shares. The transfer agent also usually compiles ownership records and distributes dividends and other mailings to security holders. A registrar assures that the number of outstanding shares does not exceed the number authorized. In doing this, it reviews transfer registrations to see that no more shares are issued than are cancelled. If a transfer agent or registrar is used, TBCA 2.19(A) (Supp. 1975) permits the corporate officers' signatures to be facsimile (*i.e.*, printed), so long as there is a countersignature by the agent or registrar, who is not corporation or its employee. Most transfer agents and registrars are banks.

274. See note 273 *supra*.

275. *Id.*

276. See notes 271-72 *supra*. Other provisions might be included in preferred stock, particularly:

(1) a sinking fund, to accumulate money for redemption (*see* note 304 *infra*); (2) negative covenants designed to keep the company in financial position to assure preferred dividends and redemptions (*e.g.*, special restrictions on dividends on common shares (*see* note 282 *infra*), restrictions or prohibitions on corporate repurchases of shares, especially when preferred dividends are in arrears (*see* notes 283, 324 *infra*), or restrictions or prohibitions on corporate issuance of debt securities (*see* note 297 *infra*); and (3) conversion rights (*see* note 373 *infra* and accompanying text). The back of the preferred certificate should also contain a stock power like the one in the text accompanying notes 265-68 *supra*. Transfer restrictions will normally be necessary if the stock is issued in a private placement. *See* note 264 *supra* and accompanying text.

Article 4 of the Articles of Incorporation, which is subject to amendment in accordance with law, provides as follows:

4. **SHARES.** The aggregate number of shares which the corporation has authority to issue is two hundred thousand (200,000) of which: (1) one hundred thousand (100,000) are shares of 6% Preferred Stock of the par value of Twenty Five Dollars (\$25) each, with the designations, preferences, limitations and relative rights described below, and (2) one hundred thousand (100,000) are shares of Common Stock of the par value of Ten Cents (\$.10) each. All shares of Common Stock have identical rights and privileges in every respect.

(a) *Designation.* The 6% Preferred Stock and the Common Stock shall be so designated respectively.

(b) *Dividends; Cumulativity.* The holders of the Preferred Stock shall be entitled to receive, when and as declared by the Board of Directors out of any funds legally available therefor,²⁷⁷ cumulative²⁷⁸ preferential²⁷⁹ dividends in cash at the rate of, but not exceeding,²⁸⁰ 6% of the par value per annum, payable quarterly on the first days of February, May, August and November in each year. Preferred Stock dividends shall be cumulative from the date of issue.²⁸¹ So long as any of the Preferred Stock remains outstanding, no dividend shall be paid on, or declared or set apart for, the Common Stock²⁸²

277. Dividends on preferred stock are subject to essentially the same surplus, solvency and other limitations as dividends on common stock. See TBCA 2.38-2.40 (1956); HAMILTON §§ 611-29.

278. TBCA 2.12(B)(2) (Supp. 1975) permits the preferred dividends to be cumulative (*i.e.*, carried forward in priority over the common when not paid), noncumulative, or partly cumulative (*e.g.*, cumulative to extent earned). While cumulation can be undetermined in various ways, it constitutes an important protection to investors and is usually insisted upon by underwriters or stock exchanges for public issues and by knowledgeable purchasers of private or closely held issues. It is required for public utility holding companies subject to the SEC's qualitative regulation. SEC Holding Co. Act Release No. 13,106 (Feb. 16, 1956), 3 CCH FED. SEC. L. REP. ¶ 36,691, at ¶ 36,692.

279. TBCA 2.12(B)(3) (Supp. 1975) authorizes dividend preferences for one class of shares over another. See note 282 *infra* and accompanying text.

280. This language puts a ceiling on the preferred dividend, makes the stock nonparticipating, and deprives the stock of opportunities to share in the growth of the business. This is the principal disadvantage of typical preferred stock to the investor. See note 271(G) *supra*. To alter this feature, the "but not exceeding" language should be deleted, and appropriate language inserted later to this effect: "In addition, the holders of the preferred stock shall be entitled to receive, when and as declared by the board of directors out of any funds legally available therefor, a dividend per share equal to any dividend per share declared on common stock." Or the participating ratio might be 1¢ per preferred for each 2¢ per common, or any other stated ratio. Or the preferred as a class (rather than per share) might be entitled to dividends at a stated ratio to common dividends as a class, thus preserving a desired ratio between classes although the number of outstanding shares in either class might change from time to time. Dividend participation, if included, should be supported by liquidation participation. See note 285 *infra*. An alternative to participating dividends is convertibility of the preferred into common, which also permits an opportunity to share in the growth of the business. For an example see notes 363, 373 *infra* and accompanying text.

An alternative to expressing the dividend as a percentage of par value (6% of \$25 here) is to use the dollar figure (\$1.50 a share). This avoids ambiguities that may arise if the par value is altered by amendment of the articles.

281. This sentence is not required, but helps to avoid disputes about the cumulation period.

282. This sentence specifies the priority of preferred dividends over common dividends. See note 279 *supra*. In some instances it may be appropriate to impose further restrictions on payment of common dividends, for example, limiting them to a proportion

and no Common Stock shall be purchased by the corporation²⁸³ unless and until all cumulated and unpaid dividends on the then outstanding shares of Preferred Stock are paid and the full dividends thereon for the then current quarterly dividend period are paid.

(c) *Liquidation Preference.* In the event of voluntary or involuntary liquidation, dissolution or winding up of the corporation, the holders of the Preferred Stock shall be entitled to receive, after payment or provision for payment of debts, but before any distribution of assets to the holders of Common Stock, twenty-five dollars (\$25) per share plus cumulated and unpaid dividends thereon to the date fixed for the liquidation, dissolution or winding up.²⁸⁴ After such payment has been made in full to the holders of the outstanding Preferred Stock, or funds necessary for such payment have been set aside in trust for the account of such holders so as to be and continue available therefor, the holders of the Preferred Stock shall be entitled to no further distribution²⁸⁵ and the remaining assets of the corporation shall be divided and distributed among the holders of the Common Stock then outstanding according to their respective shares. If on liquidation, dissolution or winding up, the assets of the corporation so distributable among the holders of the Preferred Stock are insufficient to permit full payment to them, the entire assets shall be distributed ratably among the holders of the Preferred Stock. A consolidation or merger of the corporation, a sale or transfer of substantially all of its assets as an entirety, or a purchase or redemption

of income or surplus, or prohibiting them when the ratio of current assets to current liabilities falls below a certain level. For examples see SEC Holding Co. Act Release No. 13,106 (Feb. 16, 1956), 3 CCH FED. SEC. L. REP. ¶ 36,691, at ¶ 36,695; W. CARY, CASES AND MATERIALS ON CORPORATIONS 1254-61 (4th ed. unabr. 1969).

283. Purchase of common shares is very much like dividends on common shares from the viewpoint of the holder of preferred: each involves payments to the junior class, leaving fewer assets and liquid funds available for the preferred. So it is fairly common to prohibit such purchases when there are unpaid dividends on the preferred (as here). This is the general effect of TBCA 2.03(C) (1956) which is, limited, however, to purchases from earned surplus. Other alternatives for the articles are to prohibit such purchases entirely, prohibit them except on vote of the preferred holders, or prohibit them at certain price levels, for example above \$1 per common share.

284. TBCA 2.12(B)(4) (Supp. 1975) authorizes liquidation preferences for one class of shares over another. The base amount of the preference is here par value (which is typically the price at which the shares were issued), but is often set somewhat higher (e.g., 5% to 10%) if the liquidation is voluntary. Cumulated but unpaid dividends are usually (as here) added to the base amount of the liquidation preference; they can be omitted if there is reason to do so. If a redemption premium is desired, it should be added to the liquidation preference. See notes 285, 287 *infra*.

285. This language puts a ceiling on the amount the preferred can receive in liquidation. Like the ceiling on dividends (note 280 *supra* and accompanying text) it deprives the preferred of much possible investment value. See note 271(G) *supra*. If the preferred is made participating in dividends, it should also be made participating in liquidation by deleting this sentence and substituting:

After such payment has been made in full to the holders of the outstanding preferred stock, or funds necessary for such payment have been set aside in trust for the account of such holders so as to be and continue available therefore, the remaining assets of the corporation shall be distributed in the ratio of \$1 for each share of preferred stock to \$1 for each share of common stock.

As in the case of dividend participation, the ratio may be set at any level or may be by class rather than by share. See note 280 *supra*.

If the shares are to be redeemable at a premium above par, say 6%, the premium must be part of the liquidation preference, for the reason explained in note 287 *infra*. To accomplish this, the liquidation price would be changed from \$25 to \$26.50.

by the corporation of its shares of any class, is not a "liquidation, dissolution or winding up of the affairs of this corporation" within the meaning of this paragraph.

(d) *Redemption.* The corporation, at the option of the Board of Directors, may at any time²⁸⁶ or from time to time redeem all or any part of the Preferred Stock then outstanding by paying therefor in cash twenty-five dollars (\$25)²⁸⁷ per share plus cumulated and unpaid dividends thereon to the date fixed for redemption. If less than all of the outstanding shares of Preferred Stock are to be redeemed, the shares to be redeemed shall be selected pro-rata or by lot or by such other equitable method as the Board of Directors may determine.²⁸⁸ Notice of redemption shall be mailed, postage prepaid, to the holders of record of the shares to be redeemed at their addresses then appearing on the books of the corporation, not less than twenty (20) and not more than fifty (50) days prior to the date fixed for the redemption.²⁸⁹

(e) *Provision for Payment of Redemption Price.*²⁹⁰ On or before the date fixed for redemption, the corporation may provide for payment of a sum sufficient to redeem the shares called for redemption either (1) by setting aside

286. TBCA 2.12(B)(1) (Supp. 1975) authorizes shares with a liquidation preference to be issued subject to redemption rights. TBCA 4.09 (1956) imposes a number of restrictions on the exercise of the redemption right. In particular, redemption is barred if there is a reasonable ground for believing that it would make the corporation unable to satisfy its debts when they fall due, unless any redemption premium (*i.e.*, redemption price in excess of par value) is paid out of surplus. See HAMILTON § 646. The right to redeem is important to the corporation because through it the corporation can relieve itself of the dividend commitment and force conversion if the security is convertible. See note 367 *infra*. The right to redeem probably will be resisted by investors, who may insist that there be no right for an initial period, say five or ten years, or that any redemption include a premium. See note 287 *infra*. The SEC, in its qualitative regulation of public utility holding companies, once required that all preferreds be redeemable at any time. SEC Holding Co. Act Release 13,106 (Feb. 16, 1956), 3 CCH FED. SEC. L. REP. ¶ 36,691, at ¶ 36,692. Later, when investor resistance to redeemable issues increased during a period of high interest and dividend rates, it accepted prohibitions, for up to five years, of redemptions for refunding by debt securities at lower interest costs or by other preferred stocks at lower dividend costs. *Id.* No. 16,758 (June 22, 1970), 3 CCH FED. SEC. L. REP. ¶ 36,702. This kind of no-refunding clause was already in wide use by companies not subject to the Holding Company Act.

287. A redemption premium is often included by making the redemption price higher than the par value of the shares, say by one year's dividend, in this case 6%. Sometimes the premium declines with time, say 10% for the first three years after issue and 5% for the next three years. For a more elaborate example see the SEC guidelines for public utility holding companies. SEC Holding Co. Act Release No. 16,758 (June 22, 1970), 3 CCH FED. SEC. L. REP. ¶ 36,702 (premium equal to 12 months dividend if redeemed during the first five years, nine months dividend during the second five years, six months dividend during the third five years, and three months dividend thereafter).

Since the shares cannot be redeemed at a price higher than their liquidation preference, TBCA 4.09(A)(1) (1956), an effective redemption premium requires that the same premium be written into the liquidation preference. See note 285 *supra*. Corporate surplus must be available to cover the premium at the time of redemption. See note 286 *supra*.

288. TBCA 4.08(A) (1956) permits this method of selecting the shares to be redeemed, or other variations.

289. Notice of redemption is required by TBCA 4.08(A) (1956). The notice must state the shares to be redeemed, the date fixed for redemption, the redemption price, and the place where the holders may obtain payment on surrender of their certificates. TBCA 4.08(A) (1956). More information should be included in the notice if the security is convertible. See note 370 *infra* and accompanying text. On notice generally see Bylaw 5.01.

290. This entire provision, except for clause (1), is taken substantially from TBCA 4.08(B) (1956). Clause (1) is added for flexibility, but is not expressly authorized by statute.

the sum, separate from its other funds, in trust for the benefit of the holders of the shares to be redeemed, or (2) by depositing such sum in a bank or trust company [either one in Texas having capital and surplus of at least ten million dollars (\$10,000,000) according to its latest statement of condition, or one anywhere in the United States duly appointed and acting as transfer agent for the corporation] as a trust fund, with irrevocable instructions and authority to the bank or trust company to give or complete the notice of redemption and to pay, on or after the date fixed for redemption, the redemption price on surrender of their respective share certificates. The holders may be evidenced by a list certified by the corporation (by its president or a vice president and by its secretary or an assistant secretary) or by its transfer agent. If the corporation so provides for payment, then from and after the date fixed for redemption: (a) the shares shall be deemed to be redeemed, (b) dividends thereon shall cease to accrue, (c) such setting aside or deposit shall be deemed to constitute full payment for the shares, (d) the shares shall no longer be deemed to be outstanding, (e) the holders thereof shall cease to be shareholders with respect to such shares, and (f) the holders shall have no rights with respect thereto except the right to receive their proportionate shares of the funds so set aside or deposited (but without interest) upon the surrender of their respective certificates. Any interest accrued on funds so set aside or deposited shall belong to the corporation. If the holders of any shares do not within six (6) years after such deposit claim any amount so deposited for redemption thereof, the bank or trust company shall, on demand, pay over to the corporation the balance of the funds so deposited, and the bank or trust company shall thereupon be relieved of all responsibility to such holders.

(f) *Status of Redeemed Shares.* Shares of Preferred Stock which are redeemed shall be cancelled and shall be restored to the status of authorized but unissued shares.²⁹¹

(g) *Definition of "Cumulated and Unpaid."* "Cumulated and unpaid dividends" on a share of Preferred Stock means 6% per annum of the par value thereof for the period from the date when dividends thereon begin to cumulate to the date as of which cumulated and unpaid dividends are being determined, less the dividends previously paid thereon.²⁹²

(h) *Voting if Dividends in Arrears.*²⁹³ If at any time the cumulated and

291. TBCA 4.10(A) (1956) so provides, unless the articles specify that the shares shall not be reissued. In either case a statement of cancellation must be filed with the secretary of state. TBCA 4.10(A), (B) (1956).

292. This provision is without express statutory authority.

293. TBCA 2.29(A) (Supp. 1975) gives voting rights to all outstanding shares (including preferred) on all matters except to the extent that voting rights are denied by the articles. (There are some matters on which voting rights cannot be denied. See note 28 *supra*; note 297(A) *infra*). The paragraphs in the text give preferred shares voting rights in limited situations, and deny them in all other instances where denial is permitted by law. This is the customary pattern, but it can be varied to fit the needs of the corporation and its investors.

The specific right to elect two directors on default of six quarters' dividends is also customary. It is required for preferreds listed on the New York Stock Exchange. N.Y. STOCK EXCHANGE COMPANY MANUAL A-281 (1969). The SEC requires that public utility holding company preferred shares have the right to elect a majority of the board if the dividends are four quarters in arrears. SEC Holding Co. Act Release No. 13,106

unpaid dividends on the Preferred Stock equal or exceed \$2.25 a share (six quarterly dividends), the holders of the Preferred Stock shall have the right to elect two directors of the corporation at all meetings of the shareholders of the corporation for the election of directors held thereafter and before the voting rights terminate. Directors so elected shall hold office until their successors are elected and shall qualify, whether or not the voting rights of the holders of Preferred Stock terminate before then. Such voting rights shall terminate only when all cumulated and unpaid dividends on the then outstanding shares of Preferred Stock are paid and the full dividends thereon for the then current quarterly dividend period are paid. Whenever the holders of Preferred Stock have such voting rights, the holders shall receive notice of all meetings of shareholders.²⁹⁴ At a meeting of shareholders at which the holders of Preferred Stock have such voting rights, the holders of Preferred Stock shall be entitled to one vote for each share held and to vote as a class. A majority of the outstanding shares of Preferred Stock shall be requisite and shall constitute a quorum for the election of the two directors to be elected by the holders of the Preferred Stock. A majority of any other class or classes of shares then entitled to vote for directors shall be required to constitute a quorum for the election of directors by such other class or classes. The election of directors to be elected by the holders of any class or classes of shares at a meeting of the holders of the shares entitled to vote for such directors shall be by majority vote of the shares represented at a meeting at which a quorum is present and such election shall be valid notwithstanding that a majority of the outstanding shares entitled to vote in any other class or classes may not be present in person or by proxy at such meet-

(Feb. 16, 1956), 3 CCH FED. SEC. L. REP. ¶ 36,691, at ¶ 36,693. Underwriters of publicly issued preferreds generally insist on either the N.Y.S.E. or the SEC pattern.

As written, the text permits the preferred shareholders to elect their directors only at the next regular election, which normally will be the next annual meeting. The operative date can be advanced by permitting one or more directors or officers, or a specified percentage of the preferred shareholders to call a meeting at any time after their voting rights become effective, remove directors the preferred holders are entitled to replace, and elect the replacements. To avoid the stigma of removal, the articles might specify automatic termination of incumbents on the date of the preferred shareholders' meeting, but it then becomes necessary to designate which directors are terminated. If the preferred holders can exercise their rights immediately on occurrence of the prescribed arrearages, symmetry suggests that the common shareholders be authorized to exercise their exclusive rights immediately on payoff of the arrearages.

The voting rights of preferred holders can be written to allow them to elect additional directors rather than replacing any of the existing directors. This in effect allows them to enlarge the board with their representatives and may offer greater continuity of management.

Another possible provision is one allowing only the preferred shareholders to fill vacancies among the directors they elect. Without such a provision, a vacancy will be filled by the remaining directors (Bylaw 3.05) who probably will not be representative of the interests of the preferred holders.

Preferred stock with voting rights only on failure to pay dividends probably is not "voting stock" for purposes of a taxfree acquisition under I.R.C. §§ 368(a)(1)(B) or (C). See Rev. Rul. 72-72, 1972-1 CUM. BULL. 104 (stock issued by X Corp. in acquisition of Y Corp., not "voting stock" where, by agreement, main stockholder of X Corp. obtained irrevocable voting rights on the new stock for five years; dictum: nonvoting stock which automatically becomes voting after five years is not "voting stock"). Accordingly, noncontingent voting rights should be specified if the preferred stock is to be used in such an acquisition.

294. On notice requirements generally see Bylaw 2.05.

ing.²⁹⁵ The directors elected by the holders of Preferred Stock may be removed only by vote of such holders so long as their voting rights have not terminated.²⁹⁶

(i) *Other Voting.* The Preferred Stock shall have any other voting rights granted by statutes in force from time to time.²⁹⁷ Except for such rights and those granted by paragraph (h) above, the Preferred Stock shall have no voting rights, and sole voting rights shall be in the Common Stock (which shall have one vote per share).

C. *Provisions for Series Preferred Shares*²⁹⁸
(Paragraph 4 of Articles of Incorporation)

Contents

4. Shares

4.1 General

4.2 Authorization of Directors to Determine Certain Rights

4.3 Preferences, Limitations and Relative Rights

295. These quorum requirements should be coordinated with those in Bylaw 2.06.

296. Removal of the preferred directors only by the preferred shareholders is consistent with Bylaw 3.04 (which also sets out the procedure). However, it is worth emphasizing again here. If there is any disparity, the provision here (which is part of the articles of incorporation) would control.

297. (A) TBCA 4.03(B) (Supp. 1975) gives preferred shareholders the right to vote, as a class, on a number of matters including exchanges or reclassifications of the preferred, changes in its preferences, and creation of prior preferreds. TBCA 5.03(B) (Supp. 1975) gives the preferred similar voting rights on mergers or consolidations which would have similar effects. TBCA 5.10(A)(3) (Supp. 1975) and 6.03(A)(3) (Supp. 1975) give preferred shares voting rights on sale of assets and on dissolution of the corporation, but these are not class rights unless the articles so specify. See note 28 *supra*. The draftsman may want to repeat some or all these provisions in the articles of incorporation so the preferred holders will be more aware of them. In addition, it may be appropriate to specify class voting of the preferred on sale of assets and on dissolution.

(B) Because the economic value of preferred shares is so dependent on their legal rights, and the rights can be so easily altered by merger or charter amendment, it may be appropriate to require approval of more than a simple majority of the preferred shares (e.g., 70% or 80%) for such actions. See notes 17-18 *supra* and accompanying text; SEC Holding Co. Act Release No. 13,106 (Feb. 16, 1956), 3 CCH FED. SEC. L. REP. ¶ 36,691, at ¶¶ 36,696-98 (majority vote for merger or sale of assets, two thirds vote for alteration of preferred stock provisions or issuance of additional preferred stock); N.Y. STOCK EXCHANGE COMPANY MANUAL A-281 (1969) (two thirds vote for material alteration of preferred stock provisions).

(C) The TBCA provisions cited in ¶ (A) *supra* give preferred shareholders reasonable protection against dilution or subordination by the issuance of other preferred shares. But they give no protection against the more serious dilution or subordination that can result from the issuance of debt securities. Thus the draftsman may want to consider voting rights for preferred shares on the creation of debt in some or all cases. For example, a vote of the preferred might be required for the issuance of debt with a maturity of more than one year, if the company's earnings for the last fiscal year are less than 1.5 times the interest on all debt (including the proposed debt) plus the dividends on all preferreds. For another example see the provisions required by the SEC for preferreds of public utility holding companies. SEC Holding Co. Act Release No. 13,106 (Feb. 16, 1956), 3 CCH FED. SEC. L. REP. ¶ 36,691, at ¶ 36,694.

298. These provisions would appear in the articles of incorporation. Series preferred is authorized by TBCA 2.13(A) (Supp. 1975). It has distinct advantages of flexibility and speed over the traditional preferred, all of whose terms must be spelled out in the articles of incorporation. See text accompanying notes 276-97 *supra*. With series preferred, the skeletal terms are included in the articles, and the critical economic terms (dividend rate, liquidation preference, redemption price, conversion ratio, etc.) are set by directors' resolution without the need for notice to or vote by shareholders. (Specific

- (A) General
- (B) Dividends
 - (1) Amount; Time
 - (2) Cumulativity
 - (3) Priority over Common; Restriction on Purchases of Common
 - (4) Parity Among Series
- (C) Liquidation Preference
- (D) Redemption
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 - (4) Provision for Payment
 - (5) Status of Redeemed Shares
- (E) Purchase
- (F) Voting

4. SHARES.

4.1 *General.*

The aggregate number of shares which the corporation has authority to issue is one million five hundred thousand (1,500,000) divided into: one class of one million (1,000,000) shares of Common Stock with par value of one cent (\$.01) per share, and one class of five hundred thousand (500,000) shares of Preferred Stock with par value of one hundred dollars (\$100) per share, which may be divided into and issued in Series as follows.

4.2 *Authorization of Directors to Determine Certain Rights.*

The Board of Directors is authorized,²⁹⁹ from time to time, to divide the

authorization of directors is necessary to achieve this, but it is almost always included, since there is little point in having series preferred without it.) The resolution, when properly filed with the secretary of state, becomes an amendment of the articles. TBCA 2.13(C)-(F) (1956). Thus the terms of a series fixed by the directors can thereafter be changed only by vote of the shareholders. However, the directors can continue to create new series so long as the total number of series shares remains within the number authorized by the articles. The directors also can issue additional shares of previously created series.

The advantages of this kind of director control over terms are particularly important for a public issue of preferred, when the terms need to be tailored to market conditions at the time of sale. But even the closely held company may find the series procedure simpler and easier than the traditional form. This is true even though it intends to issue only a single series.

Series preferred should not be authorized if it is important for the shareholders to vote on the terms of newly issued securities.

For the stylistic differences between these provisions and the earlier preferred stock form see note 271(A) *supra*.

299. TBCA 2.13(B) (1956) so permits if the articles expressly authorize. The articles could give the directors authority over some terms of the preferred and fix others in the articles. Normally, as with these provisions, directors should be given the broadest possible authority. See note 298 *supra*. TBCA 2.13(A) (Supp. 1975) makes it clear that only the specified items, considered in notes 300-06 *infra* and accompanying text, are subject to variation. In all other respects, shares of the same class (*i.e.*, of different series within the class) "shall be identical." TBCA 2.13(A) (Supp. 1975). Thus the directors cannot give priority or preference to one series over another in the same class.

In exercising the authority over terms of series preferred, the directors are subject to the usual fiduciary duties not to employ it in their own favor.

Preferred Stock into Series, to designate each Series, to fix and determine separately for each Series any one or more of the following relative rights and preferences, and to issue shares of any Series then or previously designated, fixed and determined:

- (A) the rate of dividend;³⁰⁰
- (B) the price at and the terms and conditions on which shares may be redeemed;³⁰¹
- (C) the amount payable upon shares in event of involuntary liquidation;³⁰²
- (D) the amount payable upon shares in event of voluntary liquidation;³⁰³
- (E) sinking fund provisions (if any) for the redemption or purchase of shares;³⁰⁴

300. TBCA 2.13(A)(1) (Supp. 1975) so authorizes. The statutory language is broad enough to let the directors set a variable rate (e.g., 10% for the first five years and 7% thereafter) and, of course, different rates for different series. Whatever rate they set would be specified in their resolution designating the series and fixing its terms.

By referring only to "the rate of dividend," the statute apparently does not contemplate that directors can have authority to make the dividend cumulative in some series and noncumulative or partially cumulative in others. For this reason, and because cumulativeness is generally desirable (see note 278 *supra*), these provisions specify cumulativeness for all series. See text accompanying note 311 *infra*. Similarly, the statute apparently does not contemplate that the directors can have authority to make some series participating and others nonparticipating. Therefore these provisions specify nonparticipation for all series. See text accompanying notes 310, 315 *infra*. If the corporation needs both cumulative and noncumulative, or participating and nonparticipating preferences, they can be authorized by specific provisions for separate classes in the articles of incorporation. If it is important to preserve director control over these variants, the articles can authorize: (1) a class of cumulative preferred; (2) a class of noncumulative preferred; (3) a class of participating preferred; (4) a class of nonparticipating preferred, and perhaps further permutations of these (cumulative-participating, cumulative-non-participating, etc.). While the relative preferences, limitations and rights of the classes would have to be spelled out in the articles, the articles could provide for division of each class into series, and grant the directors authority to choose which series and which class to issue at any time, and to fix the variables within any series. Whether the added flexibility would be worth the cumbersome articles is an open question.

301. TBCA 2.13(A)(2) (Supp. 1975) so authorizes. The mechanics of redemption for all series are prescribed in the text accompanying notes 316-22 *infra*. The statutory language is broad enough to let the directors set: (1) a redemption premium, whether fixed or varying over time; and (2) a period during which a series can not be redeemed through refunding at lower interest or dividend costs. See note 286 *supra*. The redemption price and premium can differ from series to series. It is not clear whether the directors can make one series redeemable and another series wholly nonredeemable. However, this problem is unlikely to arise because of the usual desire of the company and its management to make all preferred shares redeemable. The redemption variables would be set in the directors' resolution designating the series and fixing its terms. For language which could be used and matters to be considered see notes 286-87 *supra* and accompanying text.

302. TBCA 2.13(A)(3) (Supp. 1975) so authorizes. Further details on liquidation preferences are in the text accompanying notes 314-15 *infra*. The liquidation preference can differ in each series and would be set in the directors' resolution designating the series and fixing its terms. In particular, any desired redemption premium should be included. See note 287 *supra*. On other aspects of liquidation preference see notes 284-85 *supra*.

303. TBCA 2.13(A)(4) (Supp. 1975) so authorizes. Note 302 *supra* and its cross references are equally applicable to this provision.

304. TBCA 2.13(A)(5) (Supp. 1975) so authorizes, except for the "if any" parenthetical clause, on which see the last paragraph of this note. A sinking fund is a periodic appropriation of company funds to be used for the redemption or other purchase of the security in question, here a preferred stock. The main variables in sinking fund provisions are: (1) the amount of the appropriation per year; (2) whether it will be administered by the company or a trustee (the latter is more common for debt issues

(F) the terms and conditions on which shares may be converted if the shares of any Series are issued with the privilege of conversion;³⁰⁵ and

(G) voting rights (including the number of votes per share, the matters on which the shares can vote, and the contingencies which make the voting rights effective).³⁰⁶

4.3 *Preferences, Limitations and Relative Rights.*

(A) *General.* All shares of Common Stock shall have identical rights with each other. Except as provided in this Article 4, all shares of preferred Stock shall have preferences, limitations, and relative rights identical with each other.³⁰⁷ Except as otherwise expressly provided by law, shares of Preferred Stock shall have only the preferences and relative rights expressly stated in this Article 4.

(B) *Dividends.*

(1) *Amount; Time.* The Preferred Stock at the time outstanding shall be entitled to receive, when and as declared by the Board of Directors, out of any funds legally available therefor,³⁰⁸ dividends at the rate

and less common for preferreds); and (3) when and how the fund and its income can be used to buy or redeem the securities (thus it is sometimes provided that no redemption premium will be paid on securities redeemed through the sinking fund). Sinking funds are generally resisted by companies because of their drain on cash flow, and sought by investors because of their contribution toward ultimate retirement of the securities. If the company comes out on top of the bargaining there will probably be no sinking fund, and these forms do not include one. For examples of detailed sinking fund provisions see 1 H. KENDRICK & J. KENDRICK, TEXAS TRANSACTION GUIDE § 3.81 [2] (1974); 7A J. RABKIN & M. JOHNSON, CURRENT LEGAL FORMS 19-1513 to -1514 (1974) (form 19.11). Convertible securities in particular are unlikely to have sinking funds because of the hope of the company and investors alike that the securities will be converted rather than redeemed.

While it is clear from the statute that the directors can create different sinking fund provisions for different series, it is less than clear that they can have a sinking fund for one series and none for another series. The parenthetical "if any" is added in this form to clarify the point and is probably within the statutory authority.

305. TBCA 2.13(A)(6) (Supp. 1975) so authorizes. The statute clearly permits conversion rights for some series and none for other series, as well as different conversion rights for different series. By TBCA 2.14-1 (Supp. 1975), conversion may be into any of the company's shares or other securities. Conversion is nearly always into the company's common stock. TBCA 2.13(A)(6) (Supp. 1975) is broad enough to let the directors: (1) set different conversion ratios (or prices) for a series at different times; (2) permit conversion only before or after certain dates; and (3) specify antidilution provisions to protect the conversion rate against devaluation through mergers, security issuances and various other transactions. The antidilution provisions will often be the same for all series of the same class and can therefore be included in the articles of incorporation (although they are not included here). For further discussion of antidilution provisions and a form see notes 376-82 *infra* and accompanying text. The conversion ratios and dates (and the antidilution provisions if they are not already in the articles) would be set in the directors' resolution designating the series and fixing its terms.

306. TBCA 2.13(A)(7) (Supp. 1975) so authorizes for "voting rights." The details in the parenthetical clause are within the apparent breadth of the statutory phrase, but are specified in the articles to minimize doubts. Additional details of voting are in the text accompanying notes 325-27 *infra*. The further voting rights would be set in the directors' resolution designating the series and fixing its terms. For language which could be used and matters to be considered see notes 293-96 *supra* and accompanying text. Since all shares have some voting rights by statute (notes 28, 297(A) *supra*), the TBCA 2.13(A)(7) (Supp. 1975) authority for the directors to vary voting rights seems to mean that the directors can give additional voting rights to some series and not to others, and clearly means that the directors can give different additional voting rights to different series.

307. TBCA 2.13(A) (Supp. 1975) so provides. See note 299 *supra*.

308. See note 277 *supra*.

fixed by the Board of Directors (pursuant to paragraph 4.2 above),³⁰⁹ and no more,³¹⁰ payable semi-annually on the 15th day of January and July each year.

(2) *Cumulativity.* Dividends on Preferred Stock shall be cumulative from date of issue.³¹¹ Cumulations of dividends shall not bear interest.

(3) *Priority over Common; Restriction on Purchases of Common.* No dividend shall be declared or paid on Common Stock,³¹² and no Common Stock shall be purchased by the corporation,³¹³ unless full dividends on outstanding Preferred Stock for all past dividend periods and for the current dividend period shall have been declared and paid.

(4) *Parity Among Series.* No dividend shall be declared on any Series of Preferred Stock: (a) for any dividend period unless all dividends cumulated for all prior dividend periods shall have been declared or shall then be declared at the same time upon all Preferred Stock then outstanding; or (b) unless a dividend for the same period shall be declared at the same time upon all Preferred Stock then outstanding in like proportion to the dividend rate then declared.

(C) *Liquidation Preference.* In event of dissolution, liquidation, or winding up of the corporation (whether voluntary or involuntary), after payment or provision for payment of debts but before any distribution to the holders of Common Stock, the holders of each Series of Preferred Stock then outstanding shall be entitled to receive the amount fixed by the Board of Directors (pursuant to paragraph 4.2 above) plus a sum equal to all cumulated but unpaid dividends (whether or not earned or declared) to the date fixed for distribution,³¹⁴ and no more.³¹⁵ All remaining assets shall be distributed pro rata among the holders of Common Stock. If the assets distributable among the holders of Preferred Stock are insufficient to permit full payment to them, the entire assets shall be distributed among the holders of the Preferred Stock in proportion to their respective liquidation preferences. None of the following events is a dissolution, liquidation, or winding up within the meaning of this paragraph: consolidation, merger, or reorganization of the corporation with any other corporation or corporations, sale of all or substantially all the assets of the corporation, or any purchase or redemption by the corporation of any of its outstanding shares.

(D) *Redemption.*

(1) *Right; Method.* All or any part of any one or more Series of Preferred Stock may be redeemed at any time or times³¹⁶ at the option of the corporation, by resolution of the Board of Directors, in accordance with the terms and conditions of this Article 4 and those fixed by the Board of Directors (pursuant to paragraph 4.2 above).³¹⁷ The corporation may re-

309. See note 300 *supra* and accompanying text.

310. See note 280 *supra*.

311. See notes 278, 281 *supra*.

312. See note 282 *supra*.

313. See note 283 *supra*.

314. See notes 302-03 *supra* and accompanying text; note 284 *supra*.

315. See note 285 *supra*.

316. See note 286 *supra*.

317. See note 301 *supra* and accompanying text; note 287 *supra*.

deem shares of any one or more Series without redeeming shares of any other Series.³¹⁸ If less than all the shares of any Series are to be redeemed, the shares of the Series to be redeemed shall be selected ratably or by lot or by any other equitable method determined by the Board of Directors.³¹⁹

(2) *Notice.* Notice shall be given to the holders of shares to be redeemed, either personally or by mail, not less than twenty (20) nor more than fifty (50) days before the date fixed for redemption.³²⁰

(3) *Payment.* Redeemed shares shall be paid in cash the amount fixed by the Board of Directors (pursuant to paragraph 4.2 above)³²¹ plus a sum equal to all cumulated but unpaid dividends (whether or not earned or declared) to the date fixed for redemption, and no more.

(4) *Provision for Payment.*³²² On or before the date fixed for redemption, the corporation may provide for payment of a sum sufficient to redeem the shares called for redemption either (1) by setting aside the sum, separate from its other funds, in trust for the benefit of the holders of the shares to be redeemed, or (2) by depositing such sum in a bank or trust company [either one in Texas having capital and surplus of at least ten million dollars (\$10,000,000) according to its latest statement of condition, or one anywhere in the United States duly appointed and acting as transfer agent of the corporation] as a trust fund, with irrevocable instructions and authority to the bank or trust company to give or complete the notice of redemption and to pay, on or after the date fixed for redemption, the redemption price on surrender of their respective share certificates. The holders may be evidenced by a list certified by the corporation (by its president or a vice president and by its secretary or an assistant secretary) or by its transfer agent. If the corporation so provides for payment, then from and after the date fixed for redemption: (a) the shares shall be deemed to be redeemed, (b) dividends thereon shall cease to accrue, (c) such setting aside or deposit shall be deemed to constitute full payment for the shares, (d) the shares shall no longer be deemed to be outstanding, (e) the holders thereof shall cease to be shareholders with respect to such shares, and (f) the holders shall have no rights with respect thereto except the right to receive (without interest) their proportionate shares of the funds so set aside or deposited upon surrender of their respective certificates, and any right to convert such shares which may exist. Any interest accrued on funds so set aside or deposited shall belong to the corporation. If the holders of the shares do not, within six (6) years after such deposit, claim any amount so deposited for redemption thereof, the bank or trust company shall upon demand pay over to the corporation the balance of the funds so deposited, and the bank or trust company shall thereupon be relieved of all responsibility to such holders.

(5) *Status of Redeemed Shares.* Shares of Preferred Stock

318. Authority to redeem one series but not another is implicit in the authority of TBCA 2.13(A)(2) (Supp. 1975) to have different redemption terms and conditions for different series.

319. See note 288 *supra*.

320. See note 289 *supra*.

321. See note 301 *supra* and accompanying text; note 287 *supra*.

322. See note 290 *supra*.

which are redeemed shall be cancelled and shall be restored to the status of authorized but unissued shares.³²³

(E) *Purchase*. Except as specified in paragraph 4.3(B)(3) nothing herein shall limit the right of the corporation to purchase any of its outstanding shares in accordance with law, by public or private transaction.³²⁴

(F) *Voting*. Except as fixed by the Board of Directors (pursuant to paragraph 4.2 above),³²⁵ and except as otherwise expressly provided by law,³²⁶ all voting power shall be in the Common Stock and none in the Preferred Stock. Where Preferred Stock as a class has voting power, all series of Preferred Stock shall be a single class.³²⁷

323. See note 291 *supra*.

324. This provision preserves the company's rights to buy its own shares. These rights are limited by TBCA 2.03 (1956 & Supp. 1975) in a number of ways (*e.g.*, requiring various forms of surplus and solvency). See generally HAMILTON § 644. TBCA 4.09 (1956) imposes further limitations on the company's right to buy its own preferred shares. The courts have taken a rather relaxed view of the limits in TBCA 2.03 (1956 & Supp. 1975). *Witter v. Triumph Smokes, Inc.*, 464 F.2d 1078 (5th Cir. 1972) (corporation estopped to deny the validity of debenture it issued in repurchase of shares, even though no surplus available); *Triumph Smokes, Inc. v. Sarlo*, 482 S.W.2d 696 (Tex. Civ. App.—Tyler 1972), *error ref. n.r.e.* (debenture issued in repurchase of shares not void, even though no surplus; corporation may not attack). See Lebowitz, *Corporations, Annual Survey of Texas Law*, 27 Sw. L.J. 85, 107-11 (1973). These decisions carefully note that they do not involve creditors or other persons whose rights are prejudiced by the repurchase. Preferred shareholders may be hurt by corporate purchases of common stock, and may therefore insist on protective provisions. See note 283 *supra* and accompanying text. Preferred shareholders may also be hurt by corporate purchases of preferred stock, especially when the value or market price has been depressed by dividend arrearages. Therefore consideration should be given to a prohibition or limitation in the articles on such purchases.

325. See note 306 *supra* and accompanying text.

326. See notes 28, 297(A) *supra*.

327. Treating all series as a single class is consistent with the statutory language, which speaks of a "class . . . divided into . . . series." TBCA 2.13(A) (Supp. 1975). It is also probably consistent with the policy of class voting, which is to protect the interests of the class as a class. The different series within a class are so similar in their rights vis à vis other classes (*e.g.*, common, or prior preferreds), and are so subject to variation in their economic terms by the directors' authority to fix these terms (see notes 299-306 *supra* and accompanying text), that their collective interests as a class are far greater than their individual interests as series.

328. (A) *General*. For corporate law purposes, a warrant is not stock but an option to buy stock. It has no voting, dividend or distribution rights. But for some other purposes, discussed later in this note, a warrant is treated much like stock. As an option, a warrant is authorized by TBCA 2.14-1 (Supp. 1975). The statute prescribes only that the warrants state their terms, times and prices. In contrast to stock certificates, for which many details are specified (see notes 247-63 *supra* and accompanying text), warrants "shall be evidenced in such manner as the board of directors shall approve." TBCA 2.14-1 (Supp. 1975). In particular, warrants may be issued in bearer form, although a closely held company would rarely do so because it prefers to know who owns its shares and the rights to acquire them. No article or bylaw provisions are necessary to authorize warrants.

(B) Drafting a warrant is mainly writing a contract to provide the desired economic terms. See generally Hayes & Reiling, *Sophisticated Financing Tool: The Warrant*, 47 HARV. BUS. REV. 137 (1969), reprinted in 1 SECURITIES L. REV. 238 (R. Stotsenburg ed. 1969); Reiling, *Warrants in Bond—Warrant Units: A Survey and Assessment*, 70 MICH. L. REV. 1411 (1972). Turning a warrant into a tax-favored qualified stock option for employees invokes a number of constraints including non-transferability of the option, maximum five-year duration, purchase price not less than fair market value of the stock at the time the option is granted, and shareholder approval. See I.R.C. § 422; TAX MANAGEMENT PORTFOLIOS No. 7-4th, *Stock Options (Statutory)—Qualification* (1968); *id.* No. 183-2d, *Stock Options (Statutory)—Taxation* (1974). For examples of

[note 328 cont'd]

qualified stock option forms see *id.* and 5 J. RABKIN & M. JOHNSON, CURRENT LEGAL FORMS, forms 12.76-.79 (1974).

(C) *Procedure.* Warrants are authorized and issued by resolution of the directors unless some restriction in the articles or bylaws prevents this. TBCA 2.14-1 (Supp. 1975) indicates that some consideration must be received by the company for the warrant, as does the law of contracts. But there are no constitutional or statutory constraints on the kind of consideration. The adequacy of the consideration is determined by the board. TBCA 2.14-1 (Supp. 1975). Often the consideration is purchase of another security of the company; sometimes it is the performance of services by an employee or by an underwriter of the company's securities. The receipt and valuation of consideration, and the authorization and issuance of the warrants should be documented in much the same manner as for common stock. See notes 188-203, 205-08 *supra* and accompanying text.

(D) *Tax Treatment.* The company realizes no taxable income on the receipt of consideration for a warrant. But, according to the Internal Revenue Service, the amount of the consideration is ordinary income on the expiration date of the warrant if the warrant is not exercised. Rev. Rul. 72-198, 1972-2 CUM. BULL. 223. However, it may be a nontaxable contribution to capital. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 4-28 (3d ed. 1971). For the holder, the warrant will normally be a capital asset, unless the holder is a dealer. The holder's exercise of the warrant is not a taxable event for him or for the company. His basis in the warrant becomes part of his basis in the stock. *Id.* He cannot tack the holding period of the warrant to his holding period for the stock. Rev. Rul. 56-572, 1956-2 CUM. BULL. 182. If he lets the warrant expire unexercised, he has a capital loss in the amount of his basis for the warrant on the expiration date. I.R.C. § 1234(b); Rev. Rul. 72-198 *supra*. All the foregoing presupposes that the holder has not received the warrant in connection with employment by the company. If he has, other and more elaborate rules come into play. See I.R.C. §§ 421-22 (qualified stock options); Treas. Reg. 1.421-6 (1975) (nonqualified options). A warrant is not "voting stock" for purposes of a taxfree acquisition under I.R.C. §§ 368(a)(1)(B) or (C). Rev. Rul. 72-198, *supra*. According to the Internal Revenue Service, a warrant is not "stock or securities," and is therefore "boot" in an otherwise taxfree acquisition under I.R.C. § 368(a)(1)(A). Treas. Reg. § 1.354-1(e) (1975). However, there is argument and authority to the contrary. See B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 14-76 to -79 (3d ed. 1971).

(E) *Accounting Treatment.* The consideration received by the company for a warrant is normally debited to an asset account or an expense account if the consideration is services. An equal amount is normally credited to capital surplus or capital in excess of par value. The consideration received on exercise of the warrant is treated like any other payment for stock: debit to asset and credit divided between stated capital (to the extent of par value of the shares issued) and capital surplus or capital in excess of par value (for the remainder). See note 201 *supra* and accompanying text. Warrants do not appear on the company's balance sheet, but are described in a footnote, usually to the common stock line, reflecting the reservation of stock to satisfy the warrants. A warrant is treated as a common stock equivalent for computation of primary earnings per share. The effect is to reduce those earnings when the common stock is selling higher than the exercise price of the warrant. Am. Inst. Cert. Pub. Accts., Acctg. Prin. Board Op. 15, ¶¶ 27, 35-38 (May 1969), 1 CCH ACCOUNTING PRINCIPLES ¶¶ 2011.27, 35-38.

(F) *Economic Character.* The warrant is not an income-producing security. It has no claim on assets until it is exercised in the purchase of stock. It is simply an opportunity for capital appreciation in tandem with the common stock, but with a smaller investment than is necessary to buy common stock. See note 334 *infra*.

(G) *Variables.* This is a self-contained warrant, with all relevant terms stated in it. For a public issue, it is more common to have a warrant agreement between the company and an agent or trustee (usually a bank), setting out all the terms, and a more concise warrant which summarizes the more basic terms of the agreement and incorporates the rest by reference. For examples see 7A J. RABKIN & M. JOHNSON, CURRENT LEGAL FORMS, forms 19.23, 19.24 (1974). For the economic variables see notes 334-36 *infra* and accompanying text.

(H) *Securities Laws.* Warrants are securities under the express language of the Securities Act of 1933, § 2(1). 15 U.S.C. § 77b(1) (1970). They are probably securities under the general language of Texas Securities Act § 4(A), TEX. REV. CIV. STAT. ANN. art. 581-4(A) (1964) ("investment contract, or any other instrument commonly known as a security"). Consequently, the same precautions should be taken as for common stock to make full disclosure to buyers and to register or find an exemption for the issuance of warrants. See note 189 *supra* and references there. Moreover, warrants constitute continuing offers of the common stock purchasable through them. They thus require continuous compliance with the antifraud and registration-or-exemption provisions,

D. Warrant³²⁸Warrant #W _____³²⁹To Purchase _____³³⁰Shares of Common Stock
(\$1 par value)

ABC Corp.

Incorporated Under the Laws of the State of Texas

Contents

- (A) Basic Terms
- (B) Corporation's Covenants as to Common Stock
- (C) Method of Exercise; Fractional Shares
- (D) Adjustment of Shares Purchasable
- (E) Limited Rights of Owner
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- (G) Transfer
- (H) Recognition of Registered Owner
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- Assignment Form
- Exercise Form

(A) *Basic Terms.* This certifies that, for value received,³³¹ the registered

from the time the warrants are issued until they are all exercised or expired. Texas has a registration exemption for offers and sales to holders of non-transferable warrants. Texas Securities Act § 5(E), TEX. REV. CIV. STAT. ANN. art. 581-5(E) (1964). But this exemption has no application to transferable warrants like the one in the text. Accordingly, exemption for this warrant must be sought under the general provisions, such as the ones for small offerings described in note 189(E) *supra*. There is no special federal exemption for warrant exercises, which must therefore seek exemption under the general provisions, such as the ones for private, small or intrastate offerings described in note 189(B), (C) *supra*. The exercise of a warrant does not permit tacking the holding period of the warrant to the holding period of the stock to meet the two-year holding requirement for resale of the stock without registration under SEC rule 144(d)(1), 17 C.F.R. § 230.144(d)(1) (1974). SEC Securities Act Release No. 5306 (Sept. 26, 1972), 1 CCH FED. SEC. L. REP. ¶ 2705F. Warrants are often issued in the pre-public financing of a company. If they cover too many common shares, they may cause problems with the state securities commissioners if the company later seeks to sell common to the public. The commissioners may regard the potential dilution from the warrants as violative of the "fair, just and equitable" standard in provisions like Texas Securities Act § 10, TEX. REV. CIV. STAT. ANN. art. 581-10 (1964). There is no fixed limit, but warrants covering more than 10% of the shares to be outstanding after the public offer are likely to raise serious questions. The questions are often answered by exercise or surrender of the warrants before the public offer.

(I) *UCC.* A transferable warrant, like this one, normally will be a security under TEX. BUS. & COMM. CODE ANN. § 8.102(a)(1) (Supp. 1975). Official Comment to UCC § 8-102, 3 TEX. BUS. & COMM. CODE ANN. 94-95 (1968); E.F. Hutton & Co. v. Manufacturers Nat'l Bank, 259 F. Supp. 513 (E.D. Mich. 1966); Art-Camera-Pix, Inc. v. Cinecom Corp., 64 Misc. 2d 764, 315 N.Y.S.2d 991 (Sup. Ct. 1970). It will therefore be governed by the transfer and other provisions of art. 8 of the UCC. TBCA 2.22(A) (Supp. 1975). See note 147 *supra* and accompanying text.

329. See note 248 *supra*.

330. The number of shares purchasable should be inserted both in numbers and in words, since this is the only place in the form where this crucial information appears.

331. A warrant, as a contract, probably requires consideration. See note 328(C) *supra*. This recitation should reduce doubts about validity.

owner³³² is entitled, subject to the terms and conditions of this Warrant, until the expiration date, to purchase the number of shares of the Common Stock, par value \$1 ("the Common Stock"), of ABC Corp. ("the Corporation") from the Corporation at the purchase price shown below, on delivery of this Warrant³³³ to the Corporation with the exercise form duly executed and payment of the purchase price (in cash or by certified or bank cashier's check payable to the order of the Corporation) for each share purchased.

Registered Owner _____

Purchase Price (until 3 p.m. Central Standard Time,

Dec. 31, 1985): Twenty Dollars (\$20) a share³³⁴

Purchase Price (thereafter until 3 p.m., Central Standard Time,

Dec. 31, 1995): Twenty Five Dollars (\$25) a share.³³⁵

Expiration date: 3 p.m., Dec. 31, 1995,³³⁶ unless terminated sooner under paragraph (L) of this Warrant.

(B) *Corporation's Covenants as to Common Stock.* Shares deliverable on the exercise of this Warrant shall, at delivery, be fully paid and non-assessable,³³⁷ free from taxes, liens, and charges with respect to their purchase. The Corporation shall take any necessary steps to assure that the par value per share of the Common Stock is at all times equal to or less than the then current Warrant purchase price per share of the Common Stock issuable pur-

332. Warrants can be in bearer form if desired. See note 328(A) *supra*.

333. This form has no provision for replacing lost warrants. A provision for lost stock certificates is in Bylaw 7.06. For a discussion of the desirability of extending a number of such bylaws to warrants and other securities see note 136(B) *supra*.

334. The investment essence of a warrant is the opportunity for the holder to benefit from an increase in the value of the common stock without making the investment necessary to buy the stock (or taking the concurrent risk of ownership). For the holder, the warrant is a leverage investment. The most critical terms of the warrant are its duration and the price at which it can be exercised to purchase stock, since these set the limits of the opportunity. The warrant holder seeks the longest duration and the lowest purchase price. The company, to avoid dilution of its outstanding shares, usually wants just the opposite. Some compromise has to be struck. One pattern of compromise, represented here, is a step-up in the purchase price after a certain number of years. There can be a whole series of step-ups. See, e.g., Texas State Securities Board, Statement of Policy on Options and Warrants (Oct. 29, 1962), 3 CCH BLUE SKY L. REP. ¶ 46,664(3)(c) (options or warrants to underwriters in connection with a public offering of securities should: (1) have exercise price step-up of 7% above public offering price each year for four years, or single step-up of 20%; (2) have maximum duration of five years; and (3) not cover more than 10% of the shares outstanding after the public offering).

Another pattern of compromise, not illustrated here, is to make the warrant callable or redeemable, at any time or after a specified time, by payment of a small stated amount. When the common stock is selling above (or worth more than) the warrant purchase price plus the redemption amount, the company can usually force exercise of the warrant by calling it for redemption. Comparable procedures for preferred stock and convertible debentures are shown and discussed in notes 286-91 *supra* and 367 *infra* and accompanying text. There is no express statutory authority for callable warrants, but they appear to be within the general grant of TBCA 2.14-1 (Supp. 1975) to the directors to set terms of options, and of TBCA 2.02(A)(8) (Supp. 1975) to the corporation to make contracts. Neither payment of redemption amounts for warrants, nor any other purchase by the company of a warrant, is expressly covered by the surplus requirements and insolvency prohibition of TBCA 2.03 (1956 & Supp. 1975) (which refer only to "shares"). But these provisions might be applied by analogy because payouts for warrants can injure senior security holders in the same way as payouts for shares when the company is in poor financial condition.

335. See note 334 *supra* and accompanying text.

336. See note 334 *supra*.

337. See note 251 *supra*.

suant to this Warrant.³³⁸ The Corporation shall at all times reserve and hold available sufficient shares of Common Stock to satisfy all conversion and purchase rights of outstanding convertible securities, options and warrants.³³⁹

(C) *Method of Exercise; Fractional Shares.* The purchase rights represented by this Warrant are exercisable at the option of the registered owner in whole at any time, or in part, from time to time, within the period above specified, provided, however, that purchase rights are not exercisable with respect to a fraction of a share of Common Stock.³⁴⁰ In lieu of issuing a fraction of a share remaining after exercise of this Warrant as to all full shares covered hereby, the Corporation shall either (1) pay therefor cash equal to the same fraction of the then current Warrant purchase price per share³⁴¹ or, at its option, (2) issue scrip³⁴² for the fraction, in registered or bearer form approved by the Board of Directors of the Corporation, which shall entitle the holder to receive a certificate for a full share of Common Stock on surrender of scrip aggregating a full share. Scrip may become void after a reasonable period (but not less than six months after the expiration date of this Warrant) determined by the Board of Directors and specified in the scrip. In case of the exercise of this Warrant for less than all the shares purchasable, the Corporation shall cancel the Warrant and execute and deliver a new Warrant of like tenor and date for the balance of the shares purchasable.

(D) *Adjustment of Shares Purchasable.* The number of shares purchasable hereunder and the purchase price per share are subject to adjustment from time to time as specified in this Warrant.

(E) *Limited Rights of Owner.* This Warrant does not entitle the owner to any voting rights or other rights as a shareholder of the Corporation, or to any other rights whatsoever except the rights herein expressed.³⁴³ No divi-

338. This is important to prevent the shares from being watered at purchase. See notes 137-38 *supra* and accompanying text. There is no problem at issuance of the warrant if the purchase price in the warrant is above the par value of the common shares. But later adjustments of the purchase price for stock dividends or other events could bring the purchase price below the par value of the common. At this point, the corporation would become obligated to do something like propose an amendment of the articles to reduce par value.

339. Reservation of stock is normally by resolution of the directors. Reserved stock should not be issued for any purpose other than satisfaction of the warrants. This warrant, like most others, does not distinguish between treasury and authorized-unissued shares, so the reservation need not distinguish either. See note 328(E) *supra*.

340. Alternatives for handling fractions, pursuant to TBCA 2.20 (Supp. 1975) include: (1) issuance of scrip, which is not stock; (2) issuance of fractional shares of stock; and (3) payoff in cash at fair value. The first alternative and a modification of the third are used here in preference to the second which complicates stock records, votes and dividend disbursements. The payoff specified in the form is based on the warrant purchase price of the share which is typically less than the fair value of the share at any time the warrant is likely to be exercised. Since the statute is permissive ("may") and apparently nonexclusive, it may not preclude the payoff provision in the form but the matter is hardly clear. The reason for using the purchase price is that it is a definite number, while the fair value could be subject to wide disagreement, especially in a closely held company without active trading in its shares.

341. See note 340 *supra*.

342. *Id.*

343. Despite language of this kind, a warrant holder may have the right to bring a derivative suit in behalf of the corporation. See *Entel v. Guilden*, 223 F. Supp. 129

dends are payable or will accrue on this Warrant or the shares purchasable hereunder until, and except to the extent that, this Warrant is exercised.

(F) *Exchange for Other Denominations.* This Warrant is exchangeable, on its surrender by the registered owner to the Corporation, for new Warrants of like tenor and date representing in the aggregate the right to purchase the number of shares purchasable hereunder in denominations designated by the registered owner at the time of surrender.

(G) *Transfer.* Except as otherwise above provided, this Warrant is transferable only³⁴⁴ on the books of the Corporation by the registered owner in person or by attorney, on surrender of this Warrant, properly indorsed.³⁴⁵

(H) *Recognition of Registered Owner.* Prior to due presentment for registration of transfer of this Warrant, the Corporation may treat the registered owner as the person exclusively entitled to receive notices and otherwise to exercise rights hereunder.³⁴⁶

(I) *Effect of Stock Split, etc.*³⁴⁷ If the Corporation, by stock dividend, split, reverse split, reclassification of shares, or otherwise, changes as a whole the outstanding Common Stock into a different number or class of shares, then: (1) the number and class of shares so changed shall, for the purposes of this Warrant, replace the shares outstanding immediately prior to the change; and (2) the Warrant purchase price in effect, and the number of shares purchasable under this Warrant, immediately prior to the date upon which the change becomes effective, shall be proportionately adjusted (the price to the nearest cent). Irrespective of any adjustment or change in the Warrant purchase price or the number of shares purchasable under this or any other Warrant of like tenor, the Warrants theretofore and thereafter issued may continue to express the Warrant purchase price per share and the number of shares purchasable as the warrant purchase price per share and the number of shares purchasable were expressed in the Warrants when initially issued.

(J) *Effect of Merger, etc.*³⁴⁸ If the Corporation consolidates with or merges into another corporation, the registered owner shall thereafter be entitled on

(S.D.N.Y. 1963) (perpetual warrant, used to acquire equity capital, and traded on stock exchanges; holder has, as a matter of federal law, the right to bring a derivative suit for violation of a federal statute).

344. The statement is only partly correct. Indorsement and delivery will transfer the holder's rights to the transferee. See note 266 *supra*.

If the warrant is issued pursuant to a private offering exemption from the securities laws, it will probably be necessary to restrict the transfer of the warrant and perhaps of the stock issued on exercise. See note 264 *supra* and accompanying text.

345. On indorsement see note 266 *supra*.

346. This provision is essentially the same as Bylaw 7.08. On the possibility of extending to warrants many of the bylaw provisions on shares see note 136(B) *supra*.

347. Paragraphs (I) and (J) are antidilution provisions to protect the value of the warrants against reduction through various transactions. They do not protect the warrant against reduction in value through sale by the corporation of additional shares at a price below the warrant purchase price, although this has a dilutive effect. For other approaches to dilution protection see notes 376-81, 393-96 *infra* and accompanying text. A possible alternative approach, though rarely used, is to give warrant holders the right to vote on certain transactions which might harm them. For comparable preferred stock problems see note 297 *supra*.

348. See note 347 *supra*.

exercise to purchase, with respect to each share of Common Stock purchasable hereunder immediately before the consolidation or merger becomes effective, the securities or other consideration to which a holder of one share of Common Stock is entitled in the consolidation or merger without any change in or payment in addition to the Warrant purchase price in effect immediately prior to the merger or consolidation. The Corporation shall take any necessary steps in connection with a consolidation or merger to assure that all the provisions of this Warrant shall thereafter be applicable, as nearly as reasonably may be, to any securities or other consideration so deliverable on exercise of this Warrant. The Corporation shall not consolidate or merge unless, prior to consummation, the successor corporation (if other than the Corporation) assumes the obligations of this paragraph by written instrument executed and mailed to the registered owner at the address of the owner on the books of the Corporation. A sale or lease of all or substantially all the assets of the Corporation for a consideration (apart from the assumption of obligations) consisting primarily of securities is a consolidation or merger for the foregoing purposes.³⁴⁹

(K) *Notice of Adjustment.* On the happening of an event requiring an adjustment of the Warrant purchase price or the shares purchasable hereunder, the Corporation shall forthwith give written notice to the registered owner stating the adjusted Warrant purchase price and the adjusted number and kind of securities or other property purchasable hereunder resulting from the event and setting forth in reasonable detail the method of calculation and

349. The warrant in §§ (J) and (L) distinguishes between two basic kinds of transactions: (1) a merger, consolidation or sale of assets primarily for securities, in which case the warrant applies to the consideration received in the transaction (§ J); and (2) a liquidation in kind or sale of assets primarily for cash, in which case the warrant terminates but the holder has 30 days to exercise the warrant and become eligible for his proportion of the assets being distributed to shareholders (§ L). There will be transactions near the borderline between the two types, but it is difficult to write a provision that will sharply classify all possible transactions. A troublesome example is a spinoff of the shares of a subsidiary, which resembles both a dividend and a liquidating distribution. See *Stephenson v. Plastics Corp. of America*, 276 Minn. 400, 150 N.W.2d 668 (1967).

The rationale for the distinction is this. In the first kind of transaction, there is an ongoing business entity which can satisfy the warrant and interests in this entity are extensions, in varying degrees, of the stock originally purchasable with the warrant. Thus it is reasonable and fair for the warrant holder to have a continuing right to the equivalent in the new entity of the common stock in the original company. In the second kind of transaction, there is either no ongoing entity (when assets are distributed in kind) or no extending interests (when another entity buys the assets for cash), or neither. Consequently, it is not reasonable for the warrant holder to have a continuing right.

In the second kind of transaction, substantial value of the warrants can be destroyed if notice is not effectively given to holders. If the warrants have significant value at dissolution (i.e., if the common stock is worth significantly more than the warrant purchase price), the company would be well advised to document carefully the sending of notice, perhaps by certified or registered mail. Otherwise, it may find itself unable to prove that notice was given to all holders, and in breach of contract. See *Tisch Family Foundation, Inc. v. Texas Nat'l Petroleum Co.*, 326 F. Supp. 1128 (D. Del. 1971) (notice found not to have been given to plaintiff; \$32,295 damages awarded under Delaware law as place of incorporation); *id.* 336 F. Supp. 441 (D. Del. 1972) (interest awarded under law of Texas as place of performance). Thus there would be some protection for the company if the warrant required notice by certified mail. The protection needs to be weighed against the additional cost.

If the warrants are in bearer form, notice would have to be by some kind of publication and therefore less likely to be effective.

the facts upon which the calculation is based. The Board of Directors of the Corporation, acting in good faith, shall determine the calculation.

(L) *Notice and Effect of Dissolution, etc.* In case a voluntary or involuntary dissolution, liquidation, or winding up of the Corporation (other than in connection with a consolidation or merger covered by paragraph (J) above)³⁵⁰ is at any time proposed, the Corporation shall give at least 30 days' prior written notice to the registered owner. Such notice shall contain: (1) the date on which the transaction is to take place; (2) the record date (which shall be at least 30 days after the giving of the notice) as of which holders of Common Shares will be entitled to receive distributions as a result of the transaction; (3) a brief description of the transaction; (4) a brief description of the distributions to be made to holders of Common Shares as a result of the transaction; and (5) an estimate of the fair value of the distributions.³⁵¹ On the date of the transaction, if it actually occurs, this Warrant and all rights hereunder shall terminate.

(M) *Method of Giving Notice; Extent Required.* Notices shall be given by first class mail, postage prepaid, addressed to the registered owner at the address of the owner appearing in the records of the Corporation.³⁵² No notice to warrant holders is required except as specified in paragraphs (K)-(L).³⁵³

Witness the seal³⁵⁴ of the Corporation and the signatures of its authorized officers.³⁵⁵

Dated _____ [Seal] ABC CORP.

By

[Signature]

[Title]

[Signature]

[Title]

*Assignment Form*³⁵⁶

(To be executed by the registered owner to transfer the Warrant)

350. See note 349 *supra*.

351. On receiving a notice of dissolution, a warrant holder faces an investment decision: whether to exercise the warrant (paying the purchase price and receiving the distributions in dissolution) or let it expire. The investment decision calls for more information than the date and fact of dissolution, which is all that many warrant forms specify. Failure to supply additional information may be a violation of the securities laws. This form requires information on the nature and value of the distributions. It should be recognized that in some instances the information will not be precisely knowable, as for example when properties of uncertain value are to be distributed in kind, or when assets are being sold for cash but the amount of cash depends on an audit or appraisal. Moreover, the amount distributable per share will depend on the number of outstanding shares, which can be affected by exercise of the warrants. In short, the information probably will have to be stated in ranges or estimates.

352. A slightly more general provision on notice will be found in Bylaws 5.01-5.02 and could be used here if desired.

353. Fairness suggests giving warrant holders a reminder in advance of the expiration date, or of the date for a step-up in the purchase price. Both fairness and the securities laws suggest giving the warrant holders periodic financial statements and other relevant information on the company. These suggestions might be made requirements in the warrant. (See text accompanying note 391 *infra* (comparable provision in the text of the convertible debenture).)

354. See note 259 *supra*.

355. Absent any other specification (e.g., in the bylaws), the authorized officers are those designated by the directors. See note 328(A), (C) *supra*.

356. The assignment form is essentially the same as the one for common stock and is subject to the same comments. See notes 265-68, 270 *supra* and accompanying text.

For value received the undersigned hereby sells, assigns, and transfers to

Name _____

Address _____

this Warrant and irrevocably appoints _____

attorney (with full power of substitution) to transfer this Warrant on the books of the Corporation.

Date _____

(Please sign exactly as name
appears on Warrant)

Taxpayer ID No. _____

In the presence of _____

Signature guaranteed by _____

*Exercise Form*³⁵⁷

(To be executed by the registered owner to purchase
Common Stock pursuant to the Warrant)

ABC Corp.

1000 Texas St.

Dallas, Texas 75200

The undersigned hereby: (1) irrevocably subscribes for _____ shares of your Common Stock pursuant to this Warrant, and encloses payment of \$_____ therefor; (2) requests that a certificate for the shares be issued in the name of the undersigned and delivered to the undersigned at the address below; and (3) if such number of shares is not all of the shares purchasable hereunder, that a new Warrant of like tenor for the balance of the remaining shares purchasable hereunder be issued in the name of the undersigned and delivered to the undersigned at the address below.

Date: _____

(Please sign exactly as name appears
on Warrant)

Address: _____

Taxpayer ID No. _____

As written, the assignment form covers only an assignment of the entire warrant. This is because of the complex language which might be needed to express partial assignments when the number of shares purchasable has been adjusted. It is probably simpler to have the holder exchange his warrant for the desired denominations under ¶ (F) and then assign.

Companies will want to keep records on warrant issuance and transfer much like those on stock issuance and transfer. See note 269 *supra* and accompanying text.

357. An exercise of the warrant is a purchase of the common stock and requires compliance with the antifraud and registration-or-exemption provisions of the securities laws. For additional language which might be included in the exercise form to assist in compliance see note 435 *infra* and accompanying text.

358. (A) *General*. The convertible, subordinated redeemable note or debenture is the most versatile and complex of the basic corporate securities. Its characteristics are highlighted in this and the following notes. Corporate debt is generally authorized by

[note 358 cont'd]

TBCA 2.02(A)(9) (Supp. 1975). Convertible debt is specifically authorized by TBCA 2.14-1 (Supp. 1975). The statute prescribes only that the debt state the terms, times and ratios of conversion. In contrast to stock certificates, for which many details are specified (see notes 247-63 *supra* and accompanying text), debts "shall be evidenced in such manner as the board of directors shall approve." TBCA 2.14-1 (Supp. 1975). In particular, debt may be issued in bearer form, although a closely held company would rarely choose bearer securities for the reasons given in note 362 *infra*. No articles or bylaw provisions are necessary to authorize debt, whether or not convertible.

(B) Drafting a convertible debt is mainly writing a contract to provide the desired economic terms. See generally Katzin, *Financial and Legal Problems in Use of Convertible Securities*, 24 BUS. LAW. 359 (1969), reprinted from PROC. 7TH CORP. COUNSEL INST. 245 (1968); ¶ (F) *infra* and the references therein. Cf. Meyer, *Designing a Convertible Preferred Issue*, 46 FINANCIAL EXECUTIVE 42-62 (1968), reprinted in DRAFTING OPINIONS AND CORPORATE INSTRUMENTS 123-40 (Research and Documentation Corp. 1971). The economic character is further discussed in note 363 *infra*. This form imposes relatively few restrictions on the company and is designed for investors willing to take risks in a closely held company. See notes 363, 388 *infra*. The following notes indicate some of the changes that might be appropriate in other situations.

(C) *Procedure*. Convertible debt is authorized and issued by resolution of the directors unless some restriction in the articles or bylaws prevents this. TBCA 2.14-1 (Supp. 1975) indicates that consideration must be received by the company for the debt security, as does the law of contracts. TEX. MISC. CORP. LAWS ACT art. 1302-2.06(A), TEX. REV. CIV. STAT. ANN. art. 1302-2.06(A) (Supp. 1975) is more specific, prohibiting corporate debt except for money paid, labor done, or property actually received and reasonably worth the sum at which the labor or property is taken by the company. The adequacy of the consideration is determined by the board. *Id.*; TBCA 2.14-1 (Supp. 1975). These are essentially the same as the provisions governing the consideration received for shares. See notes 139-41, 196-97 *supra* and accompanying text. Indeed the constitutional prohibition applies identically to both kinds of securities if, as seems likely, "bonds" include all debt: "No corporation shall issue stock or bonds except for money paid, labor done or property actually received, and all fictitious increase of stock or indebtedness shall be void." TEX. CONST. art. XII, § 6. But there is no debt analogue to TBCA 2.15(A) (1956) requiring that consideration for shares equal or exceed par value. Thus debt may be issued at a discount from its face value (e.g., a \$1,000 debt for \$980 consideration). See HAMILTON § 384. However, such issuance may be subject to requirement of art. 1302-2.06(A) that the consideration be reasonably worth the amount of the debt. TEX. REV. CIV. STAT. ANN. art. 1302-2.06(A) (Supp. 1975). (Debt can be worth less than its face amount for various reasons, such as a lower than market rate of interest, or a lower probability of payment because of the company's weak financial condition.) Or this requirement may have been impliedly repealed by the 1973 enactment of TBCA 2.14-1 (Supp. 1975) which contains only the language on director approval of the adequacy of consideration and omits the reference to the reasonable worth of the consideration. Convertible securities are usually issued for cash. The receipt and valuation of consideration and the authorization and issuance of debt securities should be documented in much the same manner as for common stock. See notes 188-203, 205-08 *supra* and accompanying text. Debt securities like these notes are typically sold pursuant to an elaborate purchase agreement, which is authorized by the directors and covers such matters as: (1) company representations as to its business, finances and legal status; (2) opinion of company counsel as to the legal status of the company and the notes; (3) representations by the buyers, mainly in connection with securities law exemptions (see ¶ (G) *infra*); and (4) agreements by the company to register the notes or the common stock under the securities laws on certain conditions. For a more detailed indication of the scope of such an agreement see Bromberg, *Private Offering Checklist*, 7 REV. SEC. REG. 867 (1974).

(D) *Tax Treatment*. The company realizes no taxable income on the receipt of consideration for a debt security equal to its principal amount. Treas. Reg. § 1.61-12(c) (1) (1975). The company is merely borrowing money. Interest paid on the debt will be deductible by the company. I.R.C. § 163. And it will be ordinary income to the holder. I.R.C. § 61(a)(4). If the consideration received by the company is less than the principal amount of the debt, the difference (discount) is deductible by the company ratably over the life of the debt. Treas. Reg. § 1.163-3(a) (1975). The holder has corresponding ordinary income. I.R.C. § 1232(a)(3). If the consideration received by the company is greater than the face amount of the debt, the difference (premium) is treated as income to the company ratably over the life of the debt. Treas. Reg. § 1.61-12(c)(2), (4) (1975). The holder has a corresponding deduction. I.R.C. § 171. While the cost of issuing stock is wholly nondeductible, the cost of issuing debt (primarily legal and underwriting fees) is deductible by the company ratably over the life of the debt. Rev. Rul. 70-359, 1970-2 CUM. BULL. 103; Rev. Rul. 70-360, 1970-2 CUM. BULL. 103. The company's deductions for discount amortization and issuance costs

[note 358 cont'd]

terminate on conversion of the debt. If the debt is converted into stock of the debtor company, there is no tax to the company since the forgiven debt is considered as purchase price of the stock. I.R.C. § 1032. Nor is conversion a taxable event for the holder. Rev. Rule 72-265, 1972-1 CUM. BULL. 222. The theory is that there is no realization since there is no closed transaction but only the exercise of a right contained in the original security. *Mim.* 3156, II-2 CUM. BULL. 23 (1923). The holder's basis for the convertible security becomes his basis for the common stock and he can tack the holding period of the convertible to his holding period for the stock. A convertible security will normally be a capital asset for the holder, unless he is a dealer. Repayment of the debt at maturity or by redemption will normally be a taxfree return of capital to the holder to the extent of his basis, and capital gain above that. I.R.C. § 1232(a). Redemption of a convertible at a premium does not allow the company a deduction beyond the amount of a normal call premium on a nonconvertible debt. I.R.C. § 249. See generally B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 4-20 to -25 (3d ed. 1971); Fleischer & Cary, *The Taxation of Convertible Bonds and Stock*, 74 HARV. L. REV. 473 (1961). A convertible note is not "voting stock" for purposes of a taxfree acquisition under I.R.C. §§ 368(a)(1)(B) or (C). If sufficiently long term (*i.e.*, five years or more) it is ordinarily "stock or securities" which may be used in a taxfree acquisition under I.R.C. § 368(a)(1)(A) or recapitalization under I.R.C. § 368(a)(1)(E). See *Commissioner v. Neustadt's Trust*, 131 F.2d 528 (2d Cir. 1942) (recapitalization by exchange of 10-year 3.25% convertible debentures for outstanding 20-year 6% nonconvertible debentures). But such a transaction will precipitate tax for the recipient of the convertible if its principal amount exceeds the principal amount (if any) of the debt securities given up in exchange for it. I.R.C. § 354(a)(2). See BITTKER & EUSTICE, *supra*, 14-87 to -90, 14-75 to -79. A similarly long-term convertible debt is ordinarily "stock or securities" which may be issued in a taxfree incorporation under I.R.C. § 351(a). However, it does not seem to have the voting power necessary for the 80% "control" requirement of I.R.C. §§ 351(a) and 368(c), so the control requirement must be satisfied through other securities issued in the transaction. Most of the foregoing presupposes that the note will be treated as debt and not as equity for tax purposes. On this complicated problem see I.R.C. § 385; BITTKER & EUSTICE, *supra*, 4-5 to -43; HAMILTON § 385; Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971).

(E) *Accounting Treatment.* The consideration received by the company for a convertible note is normally debited to an asset account or an expense account if the consideration is services. The principal amount of the note is credited as a liability, and any difference between that amount and the debit is typically booked as debt premium or discount to be amortized over the life of the debt. On conversion the principal amount of the liability is eliminated by a debit, with an offsetting credit divided between stated capital to the extent of par value of the shares issued and capital surplus or capital in excess of par value (for the remainder). See note 201 *supra* and accompanying text. The convertible debt appears on the balance sheet as a liability and the conversion rights are described in a footnote. A convertible is a common stock equivalent for computation of primary earnings per share if the interest rate on the convertible is less than two thirds of the prime rate at the time of issue. The effect is to reduce those earnings when the common stock is selling higher than the conversion price. Am. Inst. Cert. Pub. Accts., Acctg. Prin. Board Op. 15, ¶¶ 25-26, 31-34 (May 1969), 1 CCH ACCOUNTING PRINCIPLES ¶¶ 2011.25-26, 31-34.

(F) *Variables.* This is a self-contained convertible note, with all relevant terms stated in it. For a public issue it is more common to have a note agreement or note indenture between the company and a trustee (usually a bank) setting out the terms, and a more concise note which summarizes the basic terms and incorporates the rest by reference. For examples see 1 H. KENDRICK & J. KENDRICK, *TEXAS TRANSACTION GUIDE* § 7.33 (1974) (note and summary of indenture); 7A J. RABKIN & M. JOHNSON, *CURRENT LEGAL FORMS*, form 19.38 (note and full indenture) (1974). In general, a public interstate offering of \$1,000,000 or more of debt securities is subject to the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-bbbb (1970). The Act imposes a number of requirements, including filings with the SEC, certain indenture terms and an independent indenture trustee. See 2 L. LOSS, *SECURITIES REGULATION* 719-53 (2d ed. 1961); *Suggested Provisions for Corporate Mortgages and Indentures Under the Trust Indenture Act, With Explanatory Notes and Suggestions as to the Applicability of the Act*, 3 CCH FED. SEC. L. REP. 33,501-65. The most comprehensive and valuable forms for debt securities and indentures are in AMERICAN BAR FOUNDATION, *COMMENTARIES ON MODEL INDENTURES* (1971). For the economic variables in convertible debt see notes 363-65, 373 *infra* and accompanying text.

(G) *Securities Laws.* Convertible notes are securities within the explicit language ("note," "evidence of indebtedness") of the Securities Act of 1933, § 2(1), 15 U.S.C. § 77b(1) (1970) and Texas Securities Act § 4(A), TEX. REV. CIV. STAT. ANN. art. 581-

E. Convertible Subordinated Redeemable Note³⁵⁸Note #N _____³⁵⁹ Original Principal Amount \$ _____

ABC Corp.

Incorporated Under the Laws of the State of Texas

—% Convertible Subordinated Redeemable Note³⁶⁰

Due April 1, 19__

ABC Corp. (the "Company"), a Texas corporation, for value received,³⁶¹ promises to pay to the Registered Holder³⁶² ("the holder"), or registered as-

4(A) (1964). Consequently, the same precautions should be taken as for common stock to make full disclosure to buyers, and to register or find an exemption for the issuance of the convertible notes. See ¶ (C) and note 189 *supra*. Moreover, convertibles constitute continuing offers of the common stock purchasable on conversion. They thus require continuous compliance with the antifraud and registration-or-exemption provisions, from the time the convertibles are issued until they are all converted or paid off. Securities Act of 1933, § 3(a)(9), 15 U.S.C. § 77c(a)(9) (1970), exempts from registration a "security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting" the exchange. This will cover most conversions, although it will not be available if someone is paid for soliciting conversion. A similar exemption from registration is granted by Texas Securities Act § 5(E), TEX. REV. CIV. STAT. ANN. art. 581-5(E) (1964) (offers to existing holders of securities, including convertibles, if no remuneration for soliciting). Cf. Texas State Securities Board Interpretation (Oct. 29, 1962), 3 CCH BLUE SKY L. REP. ¶ 46,635 (if securities underlying convertibles are once registered, continuous registration unnecessary). See also note 435 *infra* and accompanying text. On conversion a holder may tack the holding period of the convertible to his holding period for the stock to meet the two-year holding requirement for resale of the stock without registration under SEC rule 144(d)(4)(B), 17 C.F.R. § 230.144(d)(4)(B) (1974). Convertibles are often issued in the prepublic financing of a company. If they cover too many common shares, they may cause problems with state securities commissioners if the company later seeks to sell common to the public. The commissioners may regard the potential dilution from the convertibles as violative of the "fair, just and equitable" standard in provisions like Texas Securities Act § 10, TEX. REV. CIV. STAT. ANN. art. 581-10 (1964). There is no fixed limit, but convertibles covering more than 10% of the shares to be outstanding after the public offer are likely to raise questions. The questions are often answered by exercise of the conversion rights before the public offering.

(H) *U.C.C.* A convertible note like this one normally will be a security under TEX. BUS. & COMM. CODE ANN. § 8.102(a) (Supp. 1975). Even though it is privately issued by a privately held company, it is "of a type commonly dealt in upon securities exchanges or markets or commonly recognized . . . as a medium for investment." *Id.* Therefore it will be governed by the transfer and other provisions of article 8 of the Commercial Code concerning investment securities (see TEX. BUS. & COMM. CODE ANN. §§ 8.101-8.406 (1968 & Supp. 1975); TBCA 2.22(A) (Supp. 1975); note 147 *supra* and accompanying text) rather than by article 3 on commercial paper which by its own terms does not apply to investment securities (TEX. BUS. & COMM. CODE ANN. § 3.103 (a) (1968); see also *id.* § 8.102(a)(1)(B)). However, article 3 may serve as a guide to some points not covered in article 8. See C. ISRAELS & E. GUTTMAN, MODERN SECURITIES TRANSFERS 1-13 (rev. ed. 1971).

(I) *Economic Character.* See note 363 *infra*.

359. See note 248 *supra*.

360. "Redeemable" is not ordinarily included in the title of the security. A plaintiff has urged unsuccessfully that failure to include the word makes the security misleading in violation of the securities fraud provisions. *Kaplan v. Vornado*, 341 F. Supp. 212 (N.D. Ill. 1972). Nonetheless, inclusion is simple enough and may have some protective value against claims of misunderstanding or nondisclosure.

361. See note 358(C) *supra*.

362. Debt securities can be in bearer form if desired. See note 358(A) *supra*. However, closely held companies usually prefer registered form for several reasons: (1) the company knows who its creditors are and can communicate directly with them; (2) interest can be paid by check, without the cumbersome use of coupons (and corresponding complication of the drafting of the note), (3) the owner is better protected against theft or loss of the note; and (4) if the note is issued pursuant to a securities law exemption the company is in a better position to keep the exemption from being destroyed through transfers by the original buyer.

signs, the Unpaid Principal Amount on the Maturity Date, and interest at the Interest Rate on the Unpaid Principal Amount from the date of issue of this Note, semiannually on April 1 and October 1 of each year until the Unpaid Principal Amount is paid in full.

Registered Holder: _____

Original Principal Amount: \$_____ ³⁶³

Maturity Date: April 1, 19__ ³⁶⁴

Interest Rate: ____% a year. ³⁶⁵

Payments shall be in coin or currency of the United States of America

The registered form is one of the reasons the note is not a negotiable instrument under TEX. BUS. & COMM. CODE ANN. § 3.104(a) (1968). The investment character is another. See note 358(H) *supra*. But the note is a negotiable instrument within the meaning of TEX. BUS. & COMM. CODE ANN. § 8.105(a) (1968) and Article 8.

363. The investment essence of a convertible note is the combination of creditor status (including regular interest payments and priority over shareholders in the distribution of assets) with the opportunity to benefit, through the conversion right, from an increase in the value of the common stock. When the common is worth less than the conversion price, the convertible behaves like a debt security, with limited capacity to rise or fall in value in inverse relation to market rates of interest. When the common is worth more than the conversion price, the convertible behaves like the common, rising and falling in parallel with it.

The investor in a convertible note seeks the best of both worlds: debt and equity. The most critical terms of the creditor status are the maturity date, interest rate and protective provisions. See notes 364-65 *infra* and accompanying text; text accompanying notes 388-92, 402-24 *infra*. The interest rate is typically less than it would be without the conversion right. The most critical terms of the equity opportunity are the conversion price and the duration of the conversion right. The note holder seeks the longest duration and the lowest conversion price. The company, to avoid dilution of its outstanding shares, usually wants just the opposite. Some compromise has to be struck. Normally the conversion right lasts until the maturity of the note, but can be cut off earlier by redemption. See notes 372, 374 *infra* and accompanying text. Normally the conversion price is set somewhat above (e.g., 10-20%) the value of the common stock at the time the note is issued and remains flat, but it can have one or more stepups at intervals. A very important aspect of the conversion price is adjustment under the anti-dilution provisions. See notes 376-80 *infra* and accompanying text.

Typically, the company and the holder are as one in hoping that the note will never be paid, but will be converted into common stock. For this reason, and to encourage the growth of the company so that the conversion right will increase in value, a convertible note is likely to impose less stringent restrictions than a straight loan. See note 388 *infra*.

There is no need to specify a liquidation preference for principal or interest. The priority of debt over equity takes care of this. TBCA 6.04(A)(3) (Supp. 1975). *Contrast* preferred stock at notes 284-85 *supra*. Relative priorities among different classes of debt are sometimes specified. See notes 416-24 *infra* and accompanying text.

364. See note 363 *supra*.

365. *Id.* Interest has traditionally been at a fixed rate and often at a higher rate after default. Sometimes there is a step-up or step-down at fixed intervals. Occasionally the rate is lower in the early years of a company, or contingent on its earnings, to encourage its growth. However, arrangements of this kind can prejudice the tax status of the debt. More recently floating rate debt has appeared, with interest fluctuating periodically according to a formula based on the prime rate of banks, or the U.S. Treasury Bill rate. See Citicorp \$650,000,000 Floating Rates Note Due 1989 (Prospectus July 24, 1974) discussed in Thackray, *The Launching of Floating Rates*, 8 INSTITUTIONAL INVESTOR 43 (Sept. 1974).

There is no need to specify the priority of interest payments over dividends. The normal priority of debt over equity largely takes care of this, although dividend restrictions may be included. See note 388 *infra*. *Contrast* preferred stock at notes 279, 282 *supra*.

There is no need to specify cumulativeness of interest payments. Since the interest is part of the obligation, it continues to accrue if unpaid. *Contrast* preferred stock at note 278 *supra*.

Interest rates are subject to the usury laws. See, e.g., TEX. REV. CIV. STAT. ANN. art. 1302-2.09 (Supp. 1975) (allowing corporations to pay up to 1.5% a month on obligations of \$5,000 or more).

which at the time of payment is legal tender for the payment of public and private debts.

Payments shall be made at the principal office of the Company, 1000 Texas St., Dallas, Texas 75200 or at another office or agency in Dallas County, Texas of which the Company has given notice to the holder, except as provided in § 9.

TRANSFER OF THIS NOTE IS RESTRICTED. SEE § 10.

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Assignment Form

Conversion Form

1. *The Notes.* This Note is one of a series of Notes ("the Notes"), due on April 1, 19__ each in the denomination of \$25,000³⁶⁶ or a multiple thereof, issued or to be issued by the Company, in total original principal amount of \$500,000 and identical in all respects except original principal amount.

2. *Payment and Prepayment (Redemption).* The principal of this Note shall be paid, and may be prepaid or redeemed as follows.

³⁶⁶ Smaller denominations can, of course, be provided. So can mechanics for exchanging one denomination into another. See ¶ (F) of the Warrant form *supra*.

2.1 *Principal; Unpaid Principal Amount.* On the Maturity Date the Company shall pay the Unpaid Principal Amount of this Note. "Unpaid Principal Amount" means Original Principal Amount minus: (1) principal amount converted into Common Stock under § 3 and (2) principal amount redeemed under § 2.2.

2.2 *Redemption; Premium.* The Company, at its option, after giving notice, may prepay or redeem the Notes at any time(s)³⁶⁷ in whole or in part, in multiples of \$1,000 principal amount, on payment of a redemption premium equal to 10%³⁶⁸ of the principal amount being redeemed plus accrued interest on the principal amount being redeemed.

2.3 *Partial Redemption.* In a redemption of less than the entire Unpaid Principal Amount of all outstanding Notes, the amount to be redeemed shall be applied pro rata to all outstanding Notes according to their respective Unpaid Principal Amounts, and rounded, if necessary, to the nearest \$1,000 of principal amount to be redeemed.³⁶⁹

2.4 *Notice of Redemption.* Before any redemption of this Note, notice shall be given to the registered holder not less than thirty nor more than sixty days prior to the date fixed for redemption. The notice shall specify: (1) the principal amount to be redeemed; (2) the redemption premium thereon; (3) the date fixed for redemption; (4) that on the date fixed for redemption, the principal amount to be redeemed, the redemption premium and interest thereon will become due and payable, and that interest thereon will not accrue after that date; (5) the applicable conversion price on the date of the notice; (6) the date on which the right to convert the principal amount so called for redemption shall terminate [§ 2.6]; (7) an estimate of the fair

367. Redemption or prepayment of a debt security is a matter of contract without statutory regulation. The right to redeem is important to the company in many ways: (1) to relieve itself of the interest commitment, (2) to refinance its obligations more cheaply if market interest rates decline, (3) to rid itself of burdensome restrictions in the notes; and (4) to force conversion and thereby relieve itself of the obligation to pay principal as well as interest. Normally, conversion can be forced by redemption if the value or market price of the common stock is sufficiently higher than the conversion price (plus redemption premium) that holders will choose to convert and take the stock rather than accept the redemption proceeds. This is a matter of simple arithmetic if the common stock is readily saleable after conversion. In other instances there are significant judgment questions about risk and time. The right to redeem is resisted by investors, who may insist that there be no right for an initial period (*e.g.*, five or ten years) or that redemption include a high premium. See note 368 *infra*. The SEC, in its qualitative regulation of public utility holding companies, once required that all bonds be redeemable at any time. SEC Holding Co. Act Release No. 13,105 (Feb. 16, 1956), 3 CCH FED. SEC. L. REP. ¶ 36,675, at ¶ 36,680. Later, when investor resistance to redeemable issues increased during a period of high interest and dividend rates, it accepted prohibitions, for up to five years, of redemptions for refunding by debt securities at lower interest costs. *Id.* No. 16,369 (May 8, 1969), 3 CCH FED. SEC. L. REP. ¶ 36,688. This kind of no-refunding clause was already in wide use by companies not subject to the Holding Company Act. Although the note allows redemption at any time, this is subject to Note § 8.4 which tends to bar payments on the notes when there are defaults.

The notes could be made redeemable at the option of the holder, in which case they would be demand notes and quite unattractive to a company seeking longterm funds.

368. The amount of the redemption premium is negotiable. The flat amount in the text is probably less frequently used than an amount which declines with time. For a corresponding discussion on preferred stock see note 287 *supra*. In contrast to preferred stock, there is no necessity that corporate surplus be available to cover the redemption premium for debt.

369. For a more flexible provision for choosing which securities to redeem see text accompanying note 288 *supra*.

value of the Common Stock on the date of the notice;³⁷⁰ and (8) the location and address of the office or agency of the Company in Dallas County, Texas where the Note may be presented for conversion or is required to be presented for redemption (if presentment is required; see § 9), and the hours and days when the office or agency is open for business.

2.5 Effect of Redemption Notice. If redemption notice is so given, there shall become due and payable, on the date specified in the notice, the principal amount of the Note designated for redemption plus: (1) interest accrued on that principal amount to the date fixed for redemption; and (2) the redemption premium.³⁷¹ However, such principal amount (and related interest and premium) shall cease to be due and payable to the extent that the principal amount designated for redemption is converted into Common Stock under § 3.

2.6 Relation to Conversion Right. If redemption notice is so given, the right under § 3 to convert into Common Stock the principal amount of the Note designated for redemption shall continue until the close of business on the date three business days before the date fixed for redemption.³⁷² The right to convert any remaining principal amount of the Note shall not be affected by a partial redemption.

3. Conversion.

3.1 Right; Price. This Note is convertible, in multiples of \$1,000 of Unpaid Principal Amount, into shares of Common Stock of the Company (\$1 par value at present) at the conversion price then in effect ("the applicable conversion price"). The conversion price is initially \$20³⁷³ per share of

370. The estimate of value of the common stock is an unusual provision. It is designed to help the note holder decide whether to convert or take payment. It is unnecessary when there is an active market for the stock and prices or quotations are readily available. It is subject to abuse if the company exaggerates in order to encourage conversion. And there may be more effective kinds of information to give the note holder in deciding which course to choose (e.g., current financial statements and projections). For all these reasons, this kind of provision should be approached with great caution.

371. A more elaborate provision for deposit of the redemption price and cutoff of rights might be adapted from the text accompanying note 290 *supra* for preferred stock. Because of the freedom with which corporate debt can be contracted, it is probably unnecessary to make any provision concerning reissue of redeemed debt. Compare text accompanying note 291 *supra* for preferred stock.

372. Often the conversion right continues until the end of the day fixed for redemption. Here, however, it is cut off three days earlier so the company will know just how much cash it needs for the redemption and can make the necessary arrangements to have it available. If note holders need more time to decide whether to convert or be paid off, notice can be required earlier. Because of the value of the conversion right the courts require strict compliance with the terms of the note or indenture to terminate it by redemption. See *Mueller v. Howard Aircraft Corp.*, 329 Ill. App. 570, 70 N.E.2d 203 (1946). See generally Note, *Convertible Securities: Holder Who Fails To Convert Before Expiration of the Conversion Period*, 54 CORNELL L. REV. 271 (1969).

373. TBCA 2.14-1 (Supp. 1975) speaks of "conversion ratio" while the note uses "conversion price." The two terms are mathematical reciprocals. A conversion ratio of 50 (meaning 50 shares per \$1,000 of principal amount of note) is equivalent to a conversion price of \$20 a share. Put another way, the ratio times the conversion price equals the principal amount (usually \$1,000) used as a measuring unit. Conversion price is preferable for drafting because some of the antidilution provisions are much easier to write and visualize in terms of price (e.g., those involving sales of common stock at prices below the conversion price). See Note §§ 3.3, 5.1.

Concerning the initial level of the conversion price see note 363 *supra*.

Conversion into a security other than common stock or a security issued by another company is possible but not further considered here.

Common Stock and is subject to adjustment as provided below. Conversion may be made at any time, at the option of the holder, up to and including the maturity date (or, to the extent called for redemption, the date specified in § 2.6).³⁷⁴ For conversion, the holder must present this Note³⁷⁵ at the office or agency of the Company designated for payments along with: (1) the conversion form below properly executed; and (2) a properly executed assignment form if any of the shares are to be issued in a name other than the holder's.

3.2 Effect of Stock Dividend, Split, etc.³⁷⁶ If the Company splits or

374. See note 372 *supra*.

375. This form has no provision for replacing lost securities. A provision for lost stock certificates is in Bylaw 7.06. For a discussion of the desirability of extending a number of such bylaws to other kinds of securities see note 136(B) *supra*.

Nor does the form include provisions supporting a private or small offering securities law exemption for the conversion, since other exemptions are likely to be available. See note 358(G) *supra*. If the other exemptions are not available or if the exemption under which the note was originally issued may be imperilled by conversion and resale of the common stock, a clause of this kind (modeled on the text accompanying note 397 *infra*) should be added:

If requested, he shall make representations, furnish information and accept restrictions necessary, in the opinion of counsel for the Company: (1) to obtain a private or small offering exemption for the conversion under the U.S. securities laws and any applicable state laws; and (2) to preserve the exemption from such laws under which the Note was issued to the holder.

See also ¶ (4) of the Conversion Form at the end of the Note.

376. (A) *Dilution*. Dilution of the right to acquire a security at a fixed conversion price results from any event which reduces the value of the security relative to the conversion price. While it is not possible to list every event which might cause dilution many of them are obvious. They fall into four general groups, which are treated further in ¶¶ (D)-(G) of this note. First, some operate by directly increasing the number of shares outstanding without increasing the corporate assets, thereby decreasing earnings and assets per share. These are stock dividends and splits. Second, some operate by decreasing the assets of the company, and thus the assets (and probably the earnings) per share. These are dividends and other distributions in cash or property, especially those in excess of traditional dividend policy. Third, some operate by increasing the shares outstanding and increasing the corporate assets, but increasing them insufficiently. These are primarily sale of additional shares at prices below the conversion price, sale of additional securities convertible into (or with warrants to buy) the common stock below the conversion price, and issuance of options to buy the common below the conversion price. Dilution of a less drastic sort occurs if common is sold at a price below its current market value, whether this is above or below the conversion price. Fourth, some operate through merger, consolidation or sale of assets for securities in a manner similar to the first or third groups, but with the further complication that another corporate entity survives and the original company's common stock is no longer available to satisfy any conversion right. There is also reverse dilution which results from a decrease in outstanding shares caused by a reverse split or consolidation of shares. All of these present the same problems for warrants to buy at a fixed price, as they do for preferred or debt convertible at a fixed price. But the problems usually receive more attention in the case of debt because of the bargaining power of the creditor.

(B) *Extent of Protection*. The first issue for the draftsman is which kinds of dilution to protect against. This involves a balancing of the drafting complexities against the probabilities that the different kinds of events will occur and the economic damage they are likely to cause. Often this will be resolved by dealing only with stock dividends, splits and reverse splits and share reclassifications, as the most common and obvious dilutive events. No more is required by the California Commissioner of Corporations, perhaps the most alert defender of investor rights in the land. 10 CAL. ADMIN. CODE ch. 3, rule 260.140.6, 1 CCH BLUE SKY L. REP. ¶ 8617 (1973). Or, it may be appropriate to deal with some or all of the more complex dilutive events.

(C) *Methods of Protection*. Several basic types of safeguards against dilution can be written: (1) compensatory adjustment of the conversion price; (2) prohibition of the dilutive events, either absolutely or without approval of a specified portion of the note holders; (3) advance notice of the event, so that conversion rights may be exercised to take advantage of the event; and (4) advance notice and first refusal rights to partici-

[note 376 cont'd]

pate in the dilutive transaction on the same terms as those for whom it is primarily designed. The first kind is most widely used and is discussed more thoroughly in ¶¶ (D)-(F) *infra*. The second kind creates management rigidities for the company and will normally be shunned unless the investor insists otherwise and has the necessary bargaining power; it is not considered further here. The third kind is illustrated in the warrant accompanying note 350 *supra*. Cf. Note § 2.4. The fourth kind is used with some frequency for certain kinds of events. See notes 393-97 *infra* and accompanying text.

(D) *Protection Against Share Increases*. Share increases by stock split or dividend without asset increases are the easiest to compensate. If a note is convertible into common at \$20 and the common is split 2-for-1, the sensible thing is to make the note convertible at \$10, so it will yield twice as many shares before. This preserves the proportion of all shares the note holder will have on full conversion. A general formula for this kind of adjustment is:

Old Conversion Price

New Conversion Price = $\frac{\text{Old Conversion Price}}{1 + \% \text{ Increase in Outstanding Common}}$

where the increase is expressed as a decimal (100% as 1, 20% as 0.2, etc.). The formula may be written into the text, or left to determination by the directors, or as here, merely be indicated by example. See text accompanying note 377 *infra*. A 10% stock dividend does not result in a 10% decrease in the conversion price, but rather a 9.09% decrease. The decreased price, divided into the principal amount of the note, leads to a 10% increase in the number of shares issuable upon conversion. Reverse splits of the common stock increase the value of each share and call for increase of the conversion price. By appropriate drafting, price adjustments can, if desired, be rounded to the nearest cent or other convenient number, or deferred and accumulated until they reach a convenient number (such as five or ten cents a share). For somewhat similar problems of warrants see note 347 *supra* and accompanying text.

(E) *Protection Against Asset Distribution*. Often there will be no need or desire to protect conversion rights against ordinary distribution of dividends to shareholders. However, dividends and share repurchases are sometimes restricted to keep the company liquid for the creditor's benefit. See note 388 *infra*; cf. notes 282-83, 312-13 *supra* and accompanying text. His conversion right receives some incidental benefit from the restriction. To the extent dividends are payable the conversion right may need protection, particularly from extraordinary distributions to shareholders. Defining an extraordinary distribution requires criteria which might be: in partial liquidation; not out of earned surplus; or in excess of distributions for specified periods by more than a designated percent. A logical adjustment is to reduce the conversion price by the amount of the extraordinary distribution, or its value if it is property. Alternatively, the price might be adjusted by the ratio of the distribution amount or value to the then market value of the common stock, or the distribution amount or value might be made payable to the note holder along with the common stock on conversion. For clauses specifying these alternatives see AMERICAN BAR FOUNDATION, *supra* note 358(F), at 553, 547. The text does not include any of these protections. Neither the text nor this footnote covers the even more complex problem of extraordinary distributions on shares other than those into which the note is convertible. These may arise if there is participating preferred or a second class of common.

(F) *Protection Against Stock Sales*. Sales of common stock below the conversion price are plainly dilutive, and sales below the current market price of the common are less clearly dilutive. The same is true of commitments, through options, warrants and convertibles, to make such sales. A conversion price adjustment for such events is not included in the text. Rather, a right of first refusal is provided as a substitute. See note 393 *infra* and accompanying text. It is possible to specify an adjustment, although it is more complicated than the one used for stock splits and dividends (see ¶ (D) *supra*). The adjustment generally uses some sort of weighted average of the relative contribution of the old securities (at their conversion price) and the new securities (at their purchase price). For sample formulas and clauses see AMERICAN BAR FOUNDATION, *supra* note 358(F), at 530-55. For some differences in objectives and effects of the provisions see Kaplan, *Piercing the Corporate Boilerplate: Anti-Dilution Clauses in Convertible Securities*, 33 U. CHI. L. REV. 1 (1966); Kaplan, *Some Further Comments on Anti-Dilution Clauses*, 23 BUS. LAW. 893 (1968); Ratner, *Dilution and Anti-Dilution: A Reply to Professor Kaplan*, 33 U. CHI. L. REV. 494 (1966). A simpler but more drastic protection is to specify that if stock is sold below the conversion price, the conversion price will drop to the price at which the stock is sold.

(G) *Protection Against Mergers*. If the company is not the surviving entity in a merger, the simplest protection is to make the note convertible into the equivalent after the merger of the company's common stock before the merger. This is the approach of Note § 3.4 (and for warrants see text accompanying note 348 *supra*). However, this provision does not compensate for any dilution which may occur if the surviving entity issues securities worth less than the conversion price or less than the fair value of the

combines its outstanding shares of Common Stock into a greater or lesser number of shares, the applicable conversion price shall be proportionately reduced or increased, calculated to the nearest cent. If the Company pays a dividend in shares of its Common Stock, the applicable conversion price shall be proportionately reduced, calculated to the nearest cent. Examples (assuming \$20 conversion price): (1) 100% stock dividend or split: applicable conversion price becomes \$10 [$\$20 \div (1 + 100\%) = \$20/2 = \10]; (2) 10% stock dividend: applicable conversion price becomes \$18.18 [$\$20 \div (1 + 10\%) = \$20/1.10 = \18.18].³⁷⁷

3.3 *Effect of Sales Below Conversion Price, etc.*³⁷⁸ Events listed in § 5.1 give rise to a right of first refusal under § 5.2 but not to an adjustment of conversion price.

3.4 *Effect of Merger, etc.*³⁷⁹ If the Company merges with another corporation, the Note holder shall thereafter be entitled on conversion, with respect to each share of Common Stock receivable on conversion immediately before the merger becomes effective, to receive the securities or other consideration to which a holder of one share of Common Stock is entitled in the merger, without any change in, or payment in addition to, the conversion price in effect immediately before the merger.

3.5 *Covenants as to Merger.*³⁸⁰ The Company shall use its best efforts in connection with a merger to assure that § 3.4 and all other provisions of this Note shall thereafter be applicable, as nearly as reasonably may be, to any securities or other consideration so deliverable on conversion. The Company shall not merge unless, prior to consummation, the successor corporation (if other than the Company) assumes the obligations of § 3.4 and all other

company's common stock. This sometimes occurs in mergers which are not at arms length, and can occur in those which are. Nor does § 3.4 compensate for any dilution which occurs when the company, although it is the surviving entity, issues its shares for securities or assets of another company which are worth less than the conversion price or less than the fair value of the company's common stock. The latter transaction is similar to a cash sale below conversion price which gives rise to a right of first refusal under Note § 5. But Note § 5.1(2) expressly excludes issuances pursuant to a merger because of the probability that any such transaction will be at arms length and beneficial to the company. The draftsman must decide whether to try to cover these two merger patterns which are not covered by the present note.

(H) *Tax Treatment.* An adjustment of the conversion price pursuant to the terms of the note should not be a taxable event under the federal income tax laws because there is no realization of income.

(I) *Securities Laws.* An adjustment of the conversion price pursuant to the terms of the note should not be a sale under federal state securities laws, since the note holder does not give the "value" that is central to the definition of "sale." Securities Act of 1933, § 2(3), 15 U.S.C. § 77b(3) (1970); Texas Securities Act § 4(E), TEX. REV. CIV. STAT. ANN. art. 581-4(E) (1964).

377. See note 376(D) *supra*.

378. See note 376(F) *supra*; notes 393-97 *infra* and accompanying text.

379. See note 376(G) *supra*. For corresponding problems in warrants see notes 348-49 *supra* and accompanying text.

380. Corporate statutes generally specify that the survivor in a merger or consolidation is subject to all the liabilities of the constituent corporations. TBCA 5.06(A)(3), (5) (1956). But it is not clear how this provision applies to a conversion right into securities which no longer exist after the transaction. And the provision does not apply to a fusion of companies by sale or lease of assets. To deal with these gaps Note § 3.5 obliges the company, as part of the transaction, to obtain contractual assumption of the debt obligation, of the equivalent of the conversion right, and of all other terms of the note.

provisions of this Note by written instrument executed and mailed to the registered holder.

3.6 *Definition of Merger.*³⁸¹ A merger includes: (1) a sale or lease of all or substantially all the assets of the Company for a consideration (apart from the assumption of obligations) consisting primarily of securities; and (2) a consolidation.

3.7 *Notice of Adjustment or Substitution.* On the happening of an event requiring an adjustment of conversion price under § 3.2 or a substitution of securities or consideration receivable on conversion under § 3.4, the Company shall immediately give written notice to the registered holder: (1) describing the event; (2) stating the adjusted conversion price or describing the substituted securities or consideration; and (3) stating the method of calculation and the facts on which the calculation is based. The Board of Directors of the Company, acting in good faith, shall determine the calculation.

3.8 *Effect of Redemption.* See § 2.6.

3.9 *Fractional Shares.*³⁸² No fractional shares of Common Stock shall be issued on conversion. In lieu of issuing a fraction of a share, the Company shall pay therefor cash equal to the same fraction of the applicable conversion price per share.

3.10 *Interest.*³⁸³ Unless converted on a semi-annual interest payment date, no interest shall accrue or be paid from the last such date until the conversion date on the unpaid principal amount converted.

3.11 *Covenants as to Common Stock.* Shares deliverable on conversion shall, at delivery, be fully paid and nonassessable, free from taxes, liens and charges with respect to their purchase.³⁸⁴ The Company shall take any necessary steps to assure that the par value per share of the Common Stock is at all times equal to or less than the applicable conversion price.³⁸⁵ The Company shall at all times reserve and hold available sufficient shares of Common Stock to satisfy all conversion and purchase rights of its outstanding convertible securities (including the Notes), options and warrants.³⁸⁶

3.12 *Limited Rights of Note Holder.* This Note does not entitle the holder to any voting or other rights as a shareholder of the Company, or to

381. See note 380 *supra*.

382. See notes 340-42 *supra* and accompanying text.

383. This traditional provision simplifies the company's bookkeeping and saves it some expense, since conversion rarely occurs on an interest payment date unless the note holder is aware of the interest cutoff and careful to avoid it. Fairness to the investor suggests another approach, as does a recent Revenue Ruling. Rev. Rul. 74-127, 1974-1 CUM. BULL. 47. The Ruling states that an interest cutoff clause of this kind bars an accrual basis company from deducting for federal income tax purposes the accrued but unpaid interest on the notes at year-end. The reasoning is that the interest may never be paid because of the possibility of conversion, regardless of the likelihood of conversion. Presumably this is a one-time effect, since interest denied deduction in one year would be deductible the following year if paid in fact. One solution to the Ruling is to make the interest payment date on the notes the same as the end of the fiscal year (e.g., Dec. 31 or June 30 and Dec. 31) so that there will be no accrued but unpaid amounts at the end of the tax year. Another solution is to provide in the note that interest will be paid to the date of conversion. This is a fairer arrangement for the investor. A company which is on the cash basis method for tax computations is not affected, since it deducts interest only when accrued and paid.

384. See note 251 *supra* and accompanying text.

385. For a discussion of the corresponding problem for warrants see note 338 *supra*.

386. For a discussion of the corresponding problem for warrants see note 339 *supra*.

any other rights whatsoever except those herein expressed.³⁸⁷ No dividends are payable or will accrue on this Note or the shares purchasable hereunder until, and except to the extent that, the Note is converted into shares.

4. *Covenants*.³⁸⁸ The Company agrees that so long as any Note is outstanding the following provisions shall be applicable.

4.1 *Payment*. The Company shall pay the principal and interest³⁸⁹ (and redemption premium, if any) on this Note according to its terms, computing interest for any period of less than six months on the basis of a 360-day year of twelve 30-day months.

4.2 *Minimum Working Capital*.³⁹⁰

(1) The Company shall maintain working capital of at least \$500,000.00.

(2) "Working capital" means current assets minus current liabilities, all determined in accordance with generally accepted accounting principles applied on a basis consistent with that previously followed by the Company. However, the principal of the Notes shall not be considered current liabilities until due.

(3) Working capital shall be determined from the balance sheets submitted in accordance with § 4.3 below and, in the event of dispute, the determination of working capital by such accountants shall be conclusive.

387. A few states permit holders of debt securities to have voting rights like shareholders'. See DEL. CODE ANN. tit. 8, § 221 (1975). Texas has no such provision. Something very close can be achieved by contractual prohibitions on certain corporate acts, such as mergers or additional borrowings without permission of a designated proportion of the note holders. Apart from formal voting rights, note holders may exert considerable influence on the company because of their creditor position. If more complete voting rights are desired, they can be created by authorizing a special class of shares for issuance to the note holders. Compare the voting rights of preferred stock in notes 293-97 *supra* and accompanying text. Despite language of this kind denying shareholder rights to the owner of a convertible note, he may have the right to bring a derivative suit in behalf of the corporation. See *Hoff v. Sprayregen*, 339 F. Supp. 369 (S.D.N.Y. 1971) (shareholder for suit under federal securities laws and common law). But see *Brooks v. Weiser*, 57 F.R.D. 491 (S.D.N.Y. 1972) (holders of NER debentures convertible into stock of Export not shareholders of NER for suit under Delaware law). The owner of a straight (nonconvertible) debt cannot sue derivatively. *Dorfman v. Chemical Bank*, 56 F.R.D. 363 (S.D.N.Y. 1972).

388. Many other covenants may be added if their protection to the note holders outweighs their burdens on the company. See note 363 *supra*. Frequently included covenants are: (1) payment of taxes and claims by the company; (2) maintenance of properties and equipment by the company; (3) insurance of properties and equipment and perhaps of executives; (4) limitations on encumbering company property ("negative pledge"); (5) limitations on unsecured debt; (6) limitations on dividends and distributions to shareholders; and (7) limitations on repurchases of shares. Sinking funds are occasionally included. See note 304 *supra*. For a discussion of these and other covenants and sample clauses see AMERICAN BAR FOUNDATION, *supra* note 358(F), at 312-473.

Covenants in other parts of the note include Note §§ 3.5 and 3.11.

Breach of a covenant in the note is an event of default under Note § 7.1(1), (2) or (5) and may lead to acceleration under § 7.2.

If the company has or may have subsidiaries the covenants may need to be restructured, for example by making §§ 4.2-3 apply to company and subsidiaries consolidated.

389. See note 365 *supra*. A 360-day year provision simplifies calculations but, by slightly raising the effective rate for a fractional period, can create usury problems if the stated rate is close to the usury limit.

390. Many different kinds of financial requirement can be imposed, depending on the nature of the business. This is one of the simplest to write and monitor. The \$500,000 minimum amount is the same as the total principal of the notes. More might be required if there were other long-term debt outstanding. Less might suffice in some instances.

4.3 *Financial Reports*.³⁹¹ The Company shall furnish to the Note holders in reasonable detail: (1) quarterly income and surplus statements, statements of changes in financial position, and balance sheets within sixty days after the end of each quarter of the Company's fiscal year; and (2) annual income and surplus statements, statements of changes in financial position, and balance sheets as of the end of each fiscal year, within 120 days after the end of the year. The quarterly reports shall be certified by an authorized financial officer of the company and the annual reports by _____, independent certified public accountants, or by another independent certified public accountant selected by the Company acceptable to the Note holders.

4.4 *Corporate Existence*.³⁹² Subject to §§ 3.4-3.6 (certain mergers), the Company shall do or cause to be done all things necessary to preserve and keep in full force and effect its corporate existence, rights (charter and statutory) and franchises. However, the Company need not preserve a right or franchise if the Board of Directors determines that its preservation is no longer desirable in the conduct of the Company's business, and that its loss is not disadvantageous in a material respect to the Note holders.

5. *Right of First Refusal*.³⁹³

5.1 *Operative Events*. If the Company proposes to do any of the following things while any of the Notes are outstanding, then § 5.2 applies:

(1) issue shares of Common Stock for cash at a price less than the applicable conversion price, other than pursuant to options granted before the

391. The financial reports serve two general purposes: (1) to protect the note holders by keeping them informed of the company's condition, particularly relative to the working capital requirement of § 4.2; and (2) to help satisfy the antifraud provisions of the securities laws by disclosing to the note holders information that is material to the exercise of their conversion rights.

For the more meager reports customarily given to shareholders in closely held companies see note 156 *supra* and accompanying text.

392. If the covenant to maintain corporate existence is not included, voluntary dissolution should be made an event of default in § 7.1 to assure acceleration of the debt. Advance notice to note holders should be required so that they can decide whether to exercise their conversion rights. For models that could be adapted see Note § 2.4 and the text accompanying notes 350-51 *supra*. Instead of advance notice, one might provide for conversion into whatever will be distributed on dissolution. But this can become awkward without a cutoff date, since the company needs to know in advance how the assets will be divided up.

393. (A) This is a substitute for a more elaborate anti-dilution provision, which would reduce the applicable conversion price to adjust for the dilution caused by the sale or other transaction. See note 376(A)-(C) *supra*. The substitute is much easier to draft and implement. But it is not an equivalent, since it requires the note holders to invest additional money to exercise their first refusal rights and thereby protect their proportional interest in the company. If they decline to exercise, their proportional interest is reduced. A more effective antidilution provision would preserve their interest without requiring additional investment. See note 376(F) *supra*.

(B) This first refusal right by contract approximates the pre-emptive right that shareholders have by statute or common law unless denied in the articles of incorporation. See note 14 *supra* and accompanying text.

(C) This provision involves an offer of the new security to the note holders and a sale if they exercise their rights. Compliance with the securities laws is therefore essential. A registration exemption is available under Texas Securities Act § 5(E), TEX. REV. CIV. STAT. ANN. art. 581-5(E) (1964) if no commission (other than a stand-by commission) is paid for soliciting security holders. There is no comparable federal exemption, but the private offering, small offering, or intrastate exemptions may be available. See note 189(B), (C) *supra*; text accompanying note 397 *infra*.

issuance of this Note, or options granted at any time pursuant to a qualified stock option plan intended to satisfy U.S. Internal Revenue Code §§ 421-422 or comparable provisions of future laws, or options in addition to the foregoing, granted at any time on not more than 100,000 shares;³⁹⁴

(2) issue shares of Common Stock for property having a value per share less than the applicable conversion price, other than pursuant to a bona fide merger, consolidation or business acquisition;³⁹⁵

(3) issue securities convertible into shares of Common Stock of the Company at a price less than the applicable conversion price; or

(4) issue warrants, options or other rights (other than options of the three classes enumerated in paragraph (1) above) entitling the holders to purchase shares of Common Stock of the Company at a price less than the applicable conversion price.

5.2 Consequences. If the Company proposes to do any of the things listed in § 5.1, the Company shall give the Note holders at least 30 days' prior written notice and the Note holders shall have the purchase right described below. The notice shall state: (1) the date on which the securities are to be issued; (2) the price at which they are to be issued, or the cash equivalent if the securities are to be issued for property; (3) the date when payment is to be made; (4) a brief description of other relevant aspects of the transaction; and (5) that each Note holder is entitled to purchase his proportional part of 10%³⁹⁶ of the securities at the price, or cash equivalent, at which they are to be issued. His proportional part is the proportion of the unpaid principal amount of his Note to the unpaid principal amounts of all the Notes at the date of the notice. If the Note holder wishes to purchase his proportional part of the securities, he shall so notify the Company in writing not later than the close of business on the tenth day before the date on which the securities are to be issued and he shall pay for the securities on the date when payment is to be made (both dates as specified in the notice). If requested, he shall make representations, furnish information and accept restrictions necessary, in the opinion of counsel for the Company, for a private or small offering exemption under the U.S. securities laws and any applicable state laws.³⁹⁷

394. This section is rather lax in permitting unlimited qualified stock options to employees and what may be a very large number of other options relative to the company's capitalization. Tighter limits may need to be imposed.

395. See note 376(G) *supra*; note 379 *supra* and accompanying text.

396. The number here should be the note holders' proportional interest in the company's equity, measured by (A) the number of common shares to which they are entitled on conversion, divided by (B) the number of outstanding common shares or, if thought more appropriate, by (C) the number of outstanding common shares plus the number of common shares subject to warrants, options and conversion rights other than those of the notes. The number here is assumed to be 10%.

As written, the first refusal provision covers 10% of the new issue regardless of the amount of the notes outstanding at the time of the new issue. The note holders might insist on a provision like this, but it might be more reasonable to trim them down in proportion to the unpaid principal amounts of their notes. Thus if they had already converted half their notes, or half had been redeemed, they would have first refusal rights on only 5% of the new issue. To achieve this result, substitute this sentence: "His proportional part is the proportion of the unpaid principal amount of his note to the original principal amount of the Notes (\$500,000)."

397. See note 393(C) *supra*.

6. Amendments.

6.1 *By 60% Consent.* With the written consent³⁹⁸ of holders of 60%³⁹⁹ or more of the unpaid principal amount of the Notes at the time outstanding, the Company may add, delete or change provisions of the Notes (and the corresponding rights of holders) except as specified in § 6.2.

6.2 *By 100% Consent.* The written consent of holders of 100%⁴⁰⁰ of the unpaid principal amount of the Notes shall be necessary to: (1) change the maturity date; (2) reduce the principal amount; (3) reduce the interest rate; (4) extend the time for payment of interest; (5) change the method or medium of payment of principal or interest; (6) change, adversely to the Note holders, the conversion terms; or (7) change this § 6.2.

6.3 *Effect of Amendment.* An amendment under § 6.1 or 6.2 shall apply equally to all holders of the Notes then outstanding. It shall be binding upon them, upon future holders of the Notes, and upon the Company, whether or not a Note is marked to indicate the amendment.⁴⁰¹ A Note issued thereafter shall bear a notation of the amendment.

6.4 *Notice of Amendment.* The Company shall give to the Note holders immediate written notice of an amendment. The notice shall include a copy of the amendment and a copy of the consent.

7. Default.

7.1 *Event of Default Defined.*⁴⁰² Each of the following is an event of default.

(1) *Principal.* The Company does not pay the principal of any of the Notes when the same becomes due.

(2) *Interest.* The Company does not pay the interest or premium on any Note for more than 30 days after the same becomes due.

(3) *Other Debt.* The Company does not: (i) pay principal of or interest or premium on any other obligation for money borrowed (including an obligation secured by purchase money mortgage or security interest) when the same becomes due; or (ii) perform a term or condition of an agreement under which such an obligation is created, if the effect of the nonpayment

398. As written, the note does not require notice to those whose consent is not sought, nor a meeting or other opportunity to oppose. More democratic provisions might well be added.

399. The figure is negotiable. Two-thirds is probably more common in publicly held issues, or three-fourths for temporary (3-year) postponement of interest under Trust Indenture Act, § 316(a)(2), 15 U.S.C. § 77ppp(a)(2) (1971). Choosing the optimum figure presents problems similar to those for percentages required in shareholder voting. See notes 17-18 *supra* and accompanying text.

400. As written, the note requires 100% consent for modification of interest or principal of any of the notes. This provides uniformity among the note holders, and protects them from divide-and-conquer tactics. On the company's side, it causes difficulty by inhibiting negotiation with some holders for forbearance when other holders are unwilling to forbear. To alleviate this problem, the note might be rewritten to state: "The written consent of the holder of this Note shall be necessary to make any of the following changes in this Note: (1)" Or the company may seek from individual holders waivers which are not formal amendments of the notes. They may relieve financial pressures, but they are not likely to cure defaults unless all the terms of Note § 7.3 are satisfied. See also note 416(B) *infra* (on whether 100% consent should be required for broader subordination).

401. The note should be marked as soon as possible, to prevent claims of bona fide purchasers without notice of the amendment.

402. See generally AMERICAN BAR FOUNDATION, *supra* note 358(F), at 203-23.

or nonperformance is to cause, or permit the holder(s) of the obligation (or a trustee on their behalf) to cause the obligation to become due prior to its stated maturity.⁴⁰³

(4) *Misrepresentation.* A material representation or warranty made by the Company herein or in a writing furnished in connection with the purchase of this Note is false in a material respect on the date as of which made.⁴⁰⁴

(5) *Other Covenants.* The Company does not perform or observe any other agreement, covenant, term or condition hereof and the nonperformance or nonobservance is not remedied within thirty days after written notice specifying the nonperformance or nonobservance is received by the Company from one or more of the Note holders.

(6) *Assignment for Creditors.* The Company or a subsidiary makes an assignment for the benefit of creditors.

(7) *Voluntary Receivership, etc.* The Company or a subsidiary: (i) petitions or applies to a tribunal for the appointment of a trustee or receiver of the Company or a subsidiary, or of any substantial part of the assets of either; or (ii) commences a proceeding relating to the Company or a subsidiary under a bankruptcy, reorganization, arrangement, insolvency, debt readjustment, dissolution or liquidation law of any jurisdiction, whether now or hereafter in effect.

(8) *Involuntary Receivership, etc.* An involuntary receivership application is filed, or such a proceeding is commenced, against the Company or a subsidiary, and: (i) the Company or subsidiary by any act indicates its approval, consent, or acquiescence; or (ii) an order is entered appointing the trustee or receiver, or adjudicating the Company or subsidiary bankrupt or insolvent, or approving the petition in the proceeding, and the order remains in effect for more than sixty days.

(9) *Involuntary Dissolution, etc.* An order is entered in a proceeding against the Company decreeing the dissolution, winding up, liquidation, or split-up of the Company, and the order remains in effect for more than sixty days.⁴⁰⁵

7.2 Remedy: Acceleration. If an event of default occurs and continues, then the holder or holders of at least two thirds⁴⁰⁶ of the unpaid principal amount of the Notes outstanding may, at his, its or their option, by notice in writing to the Company, declare all of the unpaid principal of the Notes to be, and all of the unpaid principal of the Notes shall thereupon be, forthwith due and payable together with interest accrued thereon.⁴⁰⁷

403. The purpose here is to permit acceleration of the notes whenever other debt is accelerated, so as to preserve parity of claims.

404. A securities fraud claim would achieve much the same result, but perhaps less expeditiously. See note 358(C) *supra* (on the kind of agreement commonly used for purchase of notes of this sort).

405. See note 392 *supra*.

406. The fraction is negotiable. As written, the note does not require notice to the note holders that an event of default has occurred, although this can be very important information for enforcing their rights. Some events will be highly visible to the holders but others will not. There is some doubt about the practical effectiveness of requiring the company to notify the holders of a default, but the language can be included.

407. Texas courts have adopted a policy of strict construction of events of default

7.3 *Waiver*.⁴⁰⁸ The holders of a majority⁴⁰⁹ in unpaid principal amount of the Notes may, on behalf of all Note holders and by written consent,⁴¹⁰ waive any past default and its consequences except a default under §§ 7.1 (1), (2) or a default in respect of a covenant or provision which under § 6.2 can be changed only with the consent of all Note holders. On waiver, the underlying event(s) of default shall be deemed cured for all purposes of this Note.⁴¹¹ No waiver shall extend to a later or other default, or impair any right consequent thereto.

7.4 *Rescission of Acceleration*.⁴¹² The holders of a majority⁴¹³ in unpaid principal amount of the Notes may, on behalf of all Note holders and by written consent,⁴¹⁴ rescind and annul a declaration of acceleration under § 7.2 if the Company pays all accrued interest on the Notes then outstanding and the unpaid principal and redemption premium (if any) on the Notes then outstanding which have become due otherwise than by the declaration.⁴¹⁵ No rescission-annulment shall extend to a later or other default, or impair any right consequent thereto.

8. *Subordination*.⁴¹⁶

8.1 *In General*. The Notes (including this Note) are subordinated to and for the benefit of Senior Debt as provided in this § 8.

8.2 *Senior Debt Defined*. "Senior Debt" means the principal of and in-

and against acceleration clauses in order to avoid forfeitures. See *Ramo, Inc. v. English*, 500 S.W.2d 461 (Tex. 1973) (no acceleration for alleged violation of dividend restrictions; no finding that disputed loans to parent were dividends).

A higher rate of interest after default may be provided. See note 365 *supra*. So may interest on overdue interest.

The right of a note holder to sue for interest or principal due him hardly needs explicit statement in the note. But it can be included and must be included in an indenture subject to the Trust Indenture Act. See AMERICAN BAR FOUNDATION, *supra* note 358 (F), at 234-35.

The right of a note holder to attorneys' fees if he does sue should be covered by the text of the note when agreement is available on this point.

Any other default remedies desired, particularly foreclosure of a lien or security interest if any, should be stated.

408. The waiver provision of § 7.3 is intended to operate after default and before acceleration is declared. The rescission provision of § 7.4 is intended to operate after acceleration. See generally AMERICAN BAR FOUNDATION, *supra* note 358(F), at 220-23, 239-41. Both waiver and rescission can have substantial economic impact on note holders, and should be preceded by full disclosure of relevant material information, whether or not the action is technically the sale of a security.

409. See note 399 *supra*; notes 17-18 *supra* and accompanying text.

410. See note 398 *supra*.

411. As written, the note does not require notice to the note holders that a waiver or rescission has occurred. The company would be well advised to give such notice, and a notice requirement might be included in the note.

412. See note 408 *supra*.

413. See note 399 *supra*; notes 17-18 *supra* and accompanying text.

414. See note 398 *supra*.

415. See note 411 *supra*.

416. (A) *General*. Subordination serves a critical purpose for the company: to keep open its access to credit from traditional financial institutions which insist on priority if not collateral. Subordination is virtually essential to obtain bank loans and similar financings, especially for a company that is not well established. On subordination generally see AMERICAN BAR FOUNDATION, *supra* note 358(F), at 558-83; Calligar, *Purposes and Uses of Subordination Agreements*, 23 BUS. LAW. 33 (1967); Calligar, *Subordination Agreements*, 70 YALE L.J. 376 (1961); Everett, *Analysis of Particular Subordination Provisions*, 23 BUS. LAW. 41 (1967).

(B) *Variables*. The main variable in a subordination provision is who will have the benefit of it, or how senior debt will be defined. Note § 8.2 has a fairly standard pro-

terest and premium (if any) on debt of the Company outstanding from time to time for money borrowed from banks, insurance companies or other financial institutions regularly engaged in the business of lending.⁴¹⁷ Senior Debt does not include the Notes or obligations secured by purchase money mortgages.

8.3 *Operative Events.* Subordination shall operate in any payment or distribution of Company assets on dissolution, winding up, liquidation or reorganization of the Company (whether in receivership, bankruptcy, insolvency, assignment for benefit of creditors or other marshalling of assets and liabilities of the Company).⁴¹⁸

8.4 *Holdback for Senior Debt.* If an operative event (§ 8.3) occurs, all Senior Debt shall be paid in full before any Note holder shall receive any payment or distribution on account of the principal of or interest or redemption premium (if any) on the Notes.⁴¹⁹

8.5 *Payover to Senior Debt.* If an operative event (§ 8.3) occurs, any payment or distribution to which the Note holders would be entitled but for the holdback of § 8.4 shall be paid to the holders of the Senior Debt, in proportion to the unpaid amounts thereof, to the extent necessary to pay them

vision for subordination to banks and other financial institutions. Sometimes the subordination is only to banks or to specified debts. Sometimes it extends to trade creditors. Sometimes it is only to existing debt (and its renewals or extensions); sometimes, as here, it is to present and future debts. Sometimes it is to senior debt which expressly refers to the subordination of the notes, or does not expressly waive it. The buyers of the notes will naturally want as little subordination as possible. If the subordination is too narrow, the company may later, when pressed for funds, have to seek broader subordination from the note holders, either by separate agreements or by amendment of the notes pursuant to § 6.1 by 60% consent. If broader subordination is to require 100% consent, § 6.2 should so specify. See note 400 *supra*.

(C) *Relative Effect.* Subordination and its reverse (subrogation in § 8.7) operate only between senior and subordinated debt. Each remains a valid obligation on a parity with general or unsubordinated debt and can be paid according to its terms unless there is an operative event (§ 8.3) which triggers the subordination. See note 424 *infra* and accompanying text.

(D) *Disclosure.* Subordination is almost certainly a material term of the notes and is not easily understood by all potential buyers. Therefore it requires specially careful disclosure to avoid violations of the securities laws.

417. See note 416(B) *supra*.

418. This provision is intended to be very broad. The main things it does not cover are dividend, interest and principal payments by a solvent, continuing company. There is little or no need for subordination in these instances. Another thing it does not cover is an event of default on the senior debt which does not lead to a marshalling of assets and liabilities. Holders of senior debt sometimes insist on subordination in this additional instance. For sample clauses see AMERICAN BAR FOUNDATION, *supra* note 358(F), at 568-70.

419. Subordination typically works through two interrelated provisions. The first, a holdback (§ 8.4), gives the senior debt priority over the subordinated debt. But it does not necessarily increase the assets available to the senior debt because of uncertainty over what happens to the funds held back. The second, a payover (§ 8.5), normally increases the assets available to the senior debt and clears up the uncertainty. Assume a company with only \$3,000 of assets and \$3,000 of senior debt, \$2,000 of subordinated debt and \$1,000 of other debt. All three classes share ratably in the initial allocation, which would be \$1,500 to senior debt, \$1,000 to subordinated, and \$500 to other. The holdback by itself would prevent payment of the \$1,000 to the subordinated debt, but would not specify what would happen to the \$1,000 which might be redivided ratably between senior and other. The payover clause requires that the \$1,000 go to the senior debt, which thus collects \$2,500, while the subordinated collects nothing and the other debt collects \$500. Thus the other debt is unaffected by the subordination, which merely reallocates between the senior and subordinated debts. These results are tabulated in the "1st Distribution" columns in note 422 *infra*.

in full (after giving effect to any concurrent payment).⁴²⁰ Payments or distributions so made shall among the Company, its creditors (other than the Senior Debt holders) and the Note holders, not be deemed a payment or distribution to or on account of the Senior Debt. This § 8.5 is intended solely to define the relative rights of the Senior Debt holders and the Note holders.

8.6 Reorganization Exception. Nothing in § 8 prevents the payment or distribution to the Note holders of securities of the Company (or any other corporation) as reorganized or readjusted if: (1) the securities are subordinated at least to the extent of this § 8; (2) the Senior Debt is assumed by the new corporation, if any; and (3) the rights of the Senior Debt holders are not altered without their consent.⁴²¹

8.7 Subrogation to Senior Debt. If the Senior Debt is paid in full, the Note holders shall be subrogated to the rights of the Senior Debt holders so that any payment or distribution to which the Senior Debt holders would be entitled but for the fact that they have been paid in full through the payover of § 8.5, shall be paid to the holders of the Notes, in proportion to the unpaid amounts thereof, to the extent necessary to pay them in full (after giving effect to any concurrent payment).⁴²² Payments or distributions so made shall among the Company, its creditors (other than Senior Debt holders) and the Note holders, not be deemed a payment, or distribution to, or on account of the Notes. This § 8.7 is intended solely to define the relative rights of the senior debt holders and the Note holders.⁴²³

8.8 Nonimpairment of Notes.⁴²⁴ Nothing in § 8 impairs among the Company, its creditors (other than the Senior Debt holders) and the Note holders, the absolute and unconditional obligation to pay the principal of and interest and redemption premium (if any) on the Notes when due and payable. Subject to § 8, that obligation ranks equally with all other general obligations of the Company. Nothing in § 8 affects the relative rights of the Note holders and other creditors of the Company (other than the Senior Debt holders). Nothing in § 8 prevents the Note holders from exercising remedies

420. See notes 419, 416(C) *supra*.

421. Subordination is not needed in a reorganization of the kind described in § 8.6 and would only complicate the process.

422. Subrogation reverses the position of the senior and subordinated debt after the former is paid in full. If additional funds become available, for example through liquidation of assets in the later stages of a dissolution, those which would otherwise go to the senior debt are then paid over to the subordinated debt along with those which would go to the subordinated debt directly. Assume the facts in note 419 *supra* and that an additional \$1,200 becomes available. By initial allocation this would go \$600 to senior, \$400 to subordinated and \$200 to other. But \$500 is enough to pay senior in full (ignoring interest that may have accrued since the first distribution), so that \$100 of its allocation goes to the subordinated debt through subrogation along with \$400 directly. Finally, \$200 is paid to other debt directly. In tabular form, the results look like this.

Class	Amount	—1st Distribution—		—2d Distribution—	
		Allocation	Payment	Allocation	Payment
Senior	\$3,000	\$1,500	\$2,500	\$600	\$500
Subordinated	2,000	1,000	—0—	400	500
Other	1,000	500	500	200	200
	\$6,000	\$3,000	\$3,000	\$1,200	\$1,200

423. See note 416(C) *supra*.

424. This section is intended to make as plain as possible the limited character of the subordination. See also note 416(C) *supra*.

otherwise permitted by law on the occurrence of an event of default (§ 7.1), subject to the rights (if any) of the Senior Debt holders to receive, in accordance with § 8, payments or distributions otherwise receivable by the Note holders on the exercise of their remedies. On occurrence of an event of default, Note holders may file claims or proofs of claim but they must include a specific reference to their subordination pursuant to § 8.

8.9 *No Waiver.* No present or future holder of Senior Debt shall in any way be prejudiced or its rights to enforce subordination impaired: (1) by an act or failure to act by the Company; or (2) by noncompliance by the Company with the terms of the Notes; and in either case regardless of any knowledge such holder may have or be charged with.

9. *Payments Without Presentment.* The Company shall pay interest on, redemption premium (if any) on, and principal (except a payment of all the unpaid principal amount) of this Note pursuant to § 2. Payment shall be made by check mailed to the registered holder in accordance with § 13, without presentment of the Note and without notation of payment being made on the Note.⁴²⁵

10. *Transfer.* This Note is transferable only⁴²⁶ on the books of the Company (at its office or agency to be maintained in Dallas, Texas) by the registered holder in person or by attorney on surrender of this Note properly indorsed.⁴²⁷

THIS NOTE HAS NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933 OR UNDER ANY APPLICABLE STATE LAW. IT MAY NOT BE OFFERED FOR SALE, SOLD, TRANSFERRED OR PLEDGED WITHOUT: (1) REGISTRATION UNDER THE SECURITIES ACT OF 1933 AND ANY APPLICABLE STATE LAW; OR (2) AN OPINION (SATISFACTORY TO THE CORPORATION) OF COUNSEL (SATISFACTORY TO THE CORPORATION) THAT REGISTRATION IS NOT REQUIRED.⁴²⁸

11. *Registered Owner.* Prior to the presentment for registration of transfer of this Note the Company and any agent of the Company may treat the registered holder as the absolute owner of this Note for all purposes, whether or not the Note is overdue.⁴²⁹ Neither the Company nor the agent shall be affected by any notice to the contrary (including any notation of ownership or other writing on the Note made by anyone other than the Company).

425. Payment of interest and partial redemption proceeds by check is a great convenience to holders and company alike. There is some risk in not marking the note to show partial redemption because a bona fide buyer of the note may claim he is entitled to the full principal amount. The company should encourage submission of the notes for marking. Or the section can be redrafted to require presentment of the note for partial redemption and marking. Partial exercise of conversion rights also reduces the unpaid principal amount, but does not raise a corresponding problem, since surrender of the note is required. See text accompanying note 375 *supra*.

426. This statement is only partly correct. Indorsement and delivery will transfer all the holder's rights to the transferee. See note 266 *supra*.

427. On indorsement see note 266 *supra*.

428. See notes 264, 189(B), (E) *supra*.

429. This provision resembles Bylaw 7.08. On the possibility of extending to other securities many of the Bylaw provisions on shares see note 136(B) *supra*.

12. *No Recourse.*⁴³⁰ No recourse shall be had for the payment of the principal, interest, or redemption premium (if any) on this Note, or for any claim based hereon against an incorporator, stockholder, officer or director as such (whether past, present or future) of the Company or any successor corporation, either directly through the Company or successor corporation or otherwise, whether by virtue of a constitution, statute or rule of law or by the enforcement of an assessment or penalty or otherwise. All such liability is released and waived by the acceptance of this Note and as part of the consideration for its issuance.

13. *Notices; Addresses.* All notices to the holder or to the Company shall be given in writing by first class registered or certified United States mail, postage prepaid, addressed: (1) if to the holder, at his address most recently furnished by him to the Company for that purpose; or (2) if to the Company, at 1000 Texas Street, Dallas, Texas (Attention: President) or at such other address as the Company may specify by notice to the holders.⁴³¹ A notice by the Company of change of address of its office or agency for any payment on this Note shall be given at least ten business days before the date the change is to become effective, and shall specify such date. Checks may be sent to holders by ordinary mail, to the address indicated in clause (1).

14. *Table of Contents; Headings.* The table of contents and headings are for organization, convenience and clarity. In interpreting this Note, they shall be subordinated in importance to the other written material.

Witness the seal⁴³² of the Company and the signatures of its authorized officers.⁴³³

		ABC CORP.
Dated _____	[Seal]	By: _____
		[Signature]
		[Title]
		By: _____
		[Signature]
		[Title]

*Assignment Form*⁴³⁴

For value received _____ hereby sell, assign, and transfer to _____
 _____ all right, title and interest in and to this

430. This section is a survivor from an era when: (1) watered stock liability was far more significant than it is now with low par value, director discretion to value consideration, and the disclosure obligations of the securities laws; and (2) courts were more prone to pierce the corporate veil and impose individual liability on officers and directors. There is probably no need for the section now, and it may waive claims of note holders which other creditors are still free to enforce. See AMERICAN BAR FOUNDATION, *supra* note 358(F), at 138-39, 244-45; Annots., 40 A.L.R. 371 (1926), 87 A.L.R. 1052 (1933), 97 A.L.R. 1157 (1935); Note, 34 COLUM. L. REV. 107 (1934). Nonetheless it is comforting to management and may be included for that reason.

431. A slightly more general provision on notice will be found in Bylaws 5.01-.02 and could be integrated here if desired.

432. See note 259 *supra*.

433. Absent any other specification (e.g., in the bylaws), the authorized officers are those designated by the directors. See notes 358(A), (C) *supra*; Bylaw 8.04.

434. The assignment form is essentially the same as the one for common stock and is subject to the same comments. See notes 265-68, 270 *supra* and accompanying text.

Companies will want to keep records on note issuance and transfer much like those on stock issuance and transfer. See note 269 *supra* and accompanying text.

note in the principal amount of _____, and irrevocably appoint _____ attorney (with full power of substitution) to transfer the Note on the books of the Corporation.

Date

(Please sign exactly as name appears on Note)

In the presence of:

Taxpayer ID No.
Signature guaranteed by:

*Conversion Form*⁴³⁵

I hereby irrevocably:

(1) request conversion of \$_____ (must be \$1,000 or multiple thereof) principal amount of this Note into Common Stock of ABC Corp. in accordance with the terms of this Note;

(2) request issuance and delivery of certificate(s) for the shares of Common Stock in my name at the address shown below;

(3) request issuance and delivery of a new Note, for any unpaid principal amount not converted, in my name, at the address shown below;

(4) agree that the certificate(s) for shares of Common Stock will bear a legend in substantially this form:

THESE SHARES HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, OR UNDER ANY APPLICABLE STATE LAW. THEY MAY NOT BE OFFERED FOR SALE, SOLD, TRANSFERRED OR PLEDGED WITHOUT (1) REGISTRATION UNDER THE SECURITIES ACT OF 1933 AND ANY APPLICABLE STATE LAW OR (2) AN OPINION (SATISFACTORY TO THE COMPANY) OF COUNSEL (SATISFACTORY TO THE COMPANY) THAT REGISTRATION IS NOT REQUIRED.

(5) acknowledge that I have received the Company's annual report for its last fiscal year (including financial statements certified by independent certified public accountants) and have received or had made available to me all financial or other information which I consider necessary to an informed judgment as to the investment merits of this conversion.

Date

In the presence of

(Please sign exactly as name appears on Note)

Address

Taxpayer ID No. _____

⁴³⁵. An exercise of the conversion right is a purchase of common stock and requires compliance with the antifraud and registration-or-exemption provisions of the securities laws. See note 189 *supra*. Paragraphs (4)-(5) of the conversion form are intended to assist in that compliance. The company has a corresponding obligation to furnish the information in paragraph (5). See also note 358(G) *supra*.